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*Canada*

*Brief to the  
Royal Commission  
on Taxation*



*Submitted December, 1963 by*

THE INVESTMENT DEALERS' ASSOCIATION  
OF CANADA



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## I N D E X

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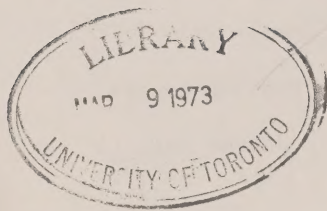
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Submitted December, 1963 through March, 1964

by

The Investment Dealers' Association of Canada

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## INTRODUCTION

The Investment Dealers' Association of Canada was formed in 1916 under the name Bond Dealers' Association of Canada, and has grown from an original membership of 32 to its present number of 189 members. The objectives of the Association, quoted from its constitution, are:

- (a) To promote the general welfare and influence of bond dealers, financial institutions and investors generally, interested in Government, Municipal and Corporation securities, and so safeguard and better provide for their protection.
- (b) To secure united protective action and to co-operate with Municipal and other Corporations in regard to legislations and methods of sound financing.
- (c) To afford opportunity for discussion and personal exchange of views on subjects of importance to the financial and commercial interests of Canada, which affect the investing public.
- (d) To afford mutual protection against loss by crime or through illegal or irregular action of Municipal or other Corporations in their financing, or through irresponsible dealers in investment securities.

The Association membership consists of 157 incorporated private companies and 32 partnerships and branches of non-resident owned firms. Of the total membership of 189, over 100 members employ 25 or fewer persons, and only 9 members employ over 200 persons. These few figures indicate the small business character of the investment dealer business, where a substantial proportion of the personnel (about 15%) are partners or shareholders of member firms or corporations.

In considering the scope of this brief, it was felt that it was preferable to have the brief prepared by Association members rather than to employ the services of professional consultants. The Association members are not, generally speaking, students of taxation theory but rather operate from a good working knowledge of those parts of various tax laws which bear on their daily business. It was concluded, therefore, that the Association's brief should be confined to relatively small areas where the specialized knowledge and experience of members could be drawn on to offer constructive suggestions to the Commission.

F. Lawson Glasgow  
President

The Investment Dealers' Association of Canada

December, 1963.

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### RECOMMENDATIONS

The following recommendations are derived from and supported by the evidence comprising Sections A - H.

#### THE INVESTMENT DEALERS' ASSOCIATION OF CANADA:

##### GENERAL RECOMMENDATION

1. that the inadequacies of the Income Tax Act be recognized and faced up to and bold measures be taken to rid the Act of its many ambiguities and conflicts--even to the point of completely re-writing the present statute and presenting a new measure dedicated to the concepts of simplicity and understandability and attuned to the present economy.

##### SPECIFIC RECOMMENDATIONS

with respect to

#### A TAX PROBLEM OF INVESTMENT DEALERS (SECTION A)

1. that the Income Tax Act be amended so that investment dealers gains or losses on the sale of securities purchased for investment be excluded from taxable income;

#### WITHHOLDING TAXES ON INCOME PAYMENTS TO NON-RESIDENTS (SECTION C)

2. that Section 108 (3a) be repealed and Section 106 of the Income Tax Act be amended to exempt from withholding tax the discount on Canadian Government and provincial treasury bills, and to exempt the interest on short-term finance company notes and commercial paper and notes having a term of one year or less from date of issue to maturity, and

3. that Section 106 (1) (b) (iv) of the Income Tax Act be amended by striking out the words "issued after June 13, 1963" to provide exemption from withholding tax on the interest from any Canadian obligations issued at any time to a person to whom a certificate of exemption has been issued under Subsection (9) - i.e., organizations which are not subject to the payment of income tax to the Governments of countries in which they are resident, and

4. that Section 106 of the Income Tax Act be amended to provide for a maximum withholding tax of 15% on dividends paid by Canadian corporations to non-residents, retaining the reduced rate of 10% in respect of dividends paid by corporations having a degree of Canadian ownership or control, and



5. that Section 110B be amended to reduce to 15% the rate of tax which was increased to 20% by the budget of June, 1963, in respect of non-resident corporations carrying on business in Canada, and

6. that Section 105D be repealed, and

7. that Section 70(2) of the Income Tax Act be amended to reduce to 15% the rate of tax which was increased to 20% by the budget of June, 1963, in respect of the taxable income of non-resident-owned investment corporations, and

8. that Section 106 of the Income Tax Act be amended to provide for a withholding tax of 15% on bond interest

- (i) except interest payable in a foreign currency
- (ii) except interest paid on bonds of or guaranteed by the Government of Canada
- (iii) except interest on bonds or other obligations of or guaranteed by a province of Canada which should be subject to a 5% tax unless payable in a foreign currency as well as Canadian
- (iv) except bonds or other obligations of or guaranteed by a municipality in Canada, where the rate should be 5% unless payable in a foreign currency as well as Canadian

and that these rates apply on all bonds or obligations presently outstanding and to be issued.

#### DEDUCTIBILITY OF FINANCING EXPENSES (SECTION D)

9. that Section 12 (1) (a) of the Income Tax Act, as further qualified by 12 (1) (c), and often referred to as the "profits earning process test", should be re-interpreted or amended so as to eliminate the inequities existing with respect to the tax treatment of "financial expenses", i.e. expenses incurred in the course of raising capital;

10. that the various sections of the Income Tax Act which, in part by regulation and in part by omission, disallow as deductions expenses incurred in the course of obtaining or utilizing funds should be revised. We suggest that all expenses related to raising debt capital, including discounts representing a commission to an underwriter, and/or part of the compensation to a lender, should be allowed as a deduction. In the case of early retirement, any unamortized balance should be deductible as of the retirement date;



priorities should be established in the area of spending and taxation programmes which affect the utilization of savings.

19. that a greater proportion of Canadian savings be channelled into equities by

- a) minimizing double taxation through increased dividend tax credits and/or lower corporate tax rates;
- b) provide tax inducements for institutional investors to place a larger share of their assets in Canadian equities.

20. that the Government apply moral suasion and positive incentives, before resorting to any kind of regulatory action with regard to conflicts which may arise between the policies and practices of non-resident owned or controlled companies in Canada and the national interest;

21. that consideration be given to measures whereby in future a foreign company wishing to set up a mining, processing, manufacturing or financial operation in Canada would be required to offer within a stated period of time (e.g. 10 years) a stated percentage of its equity in the Canadian enterprise (e.g. 25%) to the public;

22. that Canadian policy be directed towards the elimination of legislation which has the effect of discriminating against foreign capital;

23. that an effective system of preventing take-overs cannot be established without ultimately creating an extensive network of restrictions on capital movements. This would be undesirable;

24. that arrangements be made for death duties to be paid over a period of years;

25. that any remaining rate differential in the withholding tax favouring the establishment of wholly-owned subsidiary operations in this country be eliminated in the course of re-negotiation of Canada's various tax conventions;

26. that the withholding tax on interest payments should be reduced at least to the level prevailing before the Budget of December 1960. Much greater encouragement would be provided if the withholding tax on interest payments were removed entirely;

27. that the proposed discriminatory tax increase from 15% to 20% for non-qualifying corporations be rescinded while maintaining the lower (i.e. 10%) withholding rate on dividend payments by corporations which qualify under the budget provisions amended on July 8th;



28. that the qualifying period for the 10% withholding tax on dividends be extended from January 1, 1967 to January 1, 1972.

THE CANADIAN INCOME TAX ACT (SECTION H)

29. that the maximum rate of personal tax on incomes be established at 35%;

30. that the top corporation tax rate be revised to 35% and at the same time increase the tax on the lower bracket to the same figure;

31. that double taxation of corporate income be eliminated and the present bias in favour of debt financing be removed by permitting the deduction of dividends paid by corporations from the corporation's income subject to tax;

32. that a tax be established on dividends paid by Canadian corporations to non-taxpaying recipients, such as non-residents, non-taxpaying corporations, or to certain institutions (co-operatives, certain investment companies, etc.) which are not subject to the full rate of tax on dividends received. In the case of domestic corporations and those institutional investors which do not now pay the full rate of tax, this will involve the imposition of an equalizing income tax on the dividends received by such organizations. In the case of non-residents, this taxation plan would require the imposition of a tax at least equal to the maximum payable by a resident individual or corporation;

33. that the rather substantial reduction in revenues which would result initially from these proposed reductions in tax be offset by increasing or imposing sales or use taxes on goods and services;

34. that trusts, insurance companies and other major investors - and/or perhaps even all investors - should be penalized slightly for investing in foreign securities. This could be done by imposing a surtax on foreign investment income or by reducing the credit allowed against foreign taxes. If it were not considered desirable to discourage investment in foreign subsidiaries, provide special exemptions for the dividends received by the owners of substantial or controlling interests;

35. that the authorities institute a system whereby taxpayers could obtain firm rulings on the tax status of proposed transactions in advance of the actual transaction;

36. that the present confused condition of the law regarding "capital gains" be clarified to distinguish clearly between ordinary income and profits realized on the sale of investments and that all profits realised on the sale of investment securities, in the broad



sense, should continue to be exempt from tax. The Association strongly recommends against the adoption of any form of capital gains tax;

37. that a provision be introduced which would permit any non-taxed profits realized by corporations on the sale of investments to be distributed to the shareholders free of tax. This would require a procedure for the identification of such elements in the retained earnings of corporations and for the special exclusion from shareholders' income of any distributions made out of these non-taxed elements;

38. that the traditional method of introducing tax changes - complete secrecy until the full effect is announced in the budget - be eliminated and make public the principle of any new tax proposals before they are implemented so that interested taxpayers can have an opportunity to study the proposals and to assess their implications for their own business. This preliminary publication should then be followed by formal hearings before a Committee of the House at which objections could be stated, explanations given, and possible alternatives evaluated.

- End of Recommendations -



A TAX PROBLEM OF INVESTMENT DEALERS

1. Over the years there has been a trend towards the incorporation of investment dealer businesses and away from their operation as sole proprietorships or partnerships. It would appear that this trend has been caused by such factors as (1) the unwieldy nature of a partnership with an increase in the number of participants, (2) the relaxation of stock exchange rules regarding incorporated members (many investment dealers are members of or are affiliated with members of stock exchanges), and (3) the desire to limit personal liability. As pointed out in the Introduction to this brief, a fairly large number of investment dealers operate relatively small businesses, and ownership is generally closely held, so that there is a fairly free choice as to whether or not to incorporate. Existing tax laws do not appear to have any decisive effect on this decision but they are certainly a complicating factor in having to weigh the alternative effects of the graduated rates of personal tax, the two-stage corporate tax rates, the double taxation of corporate profits, and the tax credit on dividends.

2. Generally speaking, there are few contentious matters which arise in the computation of taxable income of investment dealers. One area where difficulties are encountered is in differentiating between long-term investments and securities purchased for trading purposes, and consequently separating capital gains or losses from trading profits or losses. Under the existing tax laws, the presumption seems to be that all profits from the sale of securities are taxable unless it can be proved conclusively that the securities were purchased for investment. This is very difficult to do, because an investment dealer's normal business is the trading of securities, and there are no clear-cut rules for determining what might be classed as an investment. It does not seem equitable for investment dealers to be deprived of the capability of purchasing securities for investment when others may do so. We feel that greater certainty could be established in this area and that the Income Tax Act should be amended accordingly, with the result that gains or losses on the sale of securities purchased for investment would be excluded from taxable income.

3. It is suggested that the basis of such an amendment could be to permit an investment dealer to elect the status of a security balance on or about the time of purchase, or to establish a minimum time which a balance would have to be held in order to be classed as an investment, or a combination of both of these conditions.



CANADIAN INCOME TAX STRUCTURE

1. This section of the brief discusses the Canadian tax structure under the following main headings:

Part I The effect of the tax structure on the form and cost of raising capital:

(a) Equity versus Debt Financing

(b) Capital Market versus Internal Financing

Part II The effect of the tax structure on:

(a) The degree of competition within Canada

(b) The ability of Canadian industry to compete internationally

Part III The effect of the corporation tax on the total flow of savings as an investment.

(a) EQUITY VERSUS DEBT FINANCING

2. One group of questions which the Royal Commission has asked the Association to consider concerns the effect of the tax structure on the methods by which Canadian corporations raise funds. The relevant measures are the corporate tax, the accelerated amortization provisions, the highly progressive personal income tax rates and the 20% tax credit on dividends.

(i) The corporate tax

Since interest payments on debt are deductible from corporate profits before tax and dividend payments on equity are not, corporate rates around the 50% level create an almost overwhelming bias on the part of the corporation towards debt financing.

(ii) The accelerated amortization provisions

These more generous provisions, since they are not taxable and therefore increase cash flow relative to net profit, have the effect of encouraging internal financing of capital expansion.

(iii) The highly progressive rates of personal income tax

These rates, combined with the absence of a capital gains tax, create a strong preference on the part of the individual for equity investment with capital gains potential.

(iv) The 20% tax rebate on dividends

This also creates a preference on the part of the individual for equity investment. The strong desire for equity, created by the tax free nature of inter-corporate dividends, should also be noted here.



3. It should be noted that the highly progressive personal rates and the 20% tax rebate do not apply to many institutional investors.

4. The conclusions that must be drawn from these observations is that the Canadian tax measures relevant to the form and cost of corporate financing exert opposing forces with the result that they nullify each other to some considerable extent. If there are net effects in these forces it surely is in the strong bias toward debt financing on the part of corporations and the strong preference for equity on the part of the individual produced by the highly progressive personal rates and the 20% tax rebate and on corporations by the tax free transfer of dividends between corporations.

5. It may be that these have produced higher interest rates and lower equity yields in Canada than would otherwise be the case. It may also be that the higher interest rates and lower equity yields have not produced a lesser supply of debt instruments or a greater supply of equity.

#### (b) CAPITAL MARKET VERSUS INTERNAL FINANCING

6. The provisions for accelerated amortization as shown later in the tables have somewhat increased the internal generation of cash in relation to net profit.

7. The tables also suggest that this increased generation of cash has not gone to produce a higher rate of dividend pay-out in relation to net profit. It, therefore, must have gone to increased working capital, reduction of debt or an increased degree of internal financing of capital expansion. We suggest that it has gone in all three directions. In any case, coming in a period of rising interest rates it has eased somewhat the dependance of corporations on the capital market. However, if these provisions did not exist and corporations were more dependant on outside financing, it would not lead to much greater equity offerings under the present tax structure.

8. The next section examines the National Accounts for trends during the period when the present tax structure was taking its shape.

<u>Table I</u>	<u>Corp. Profits Before Taxes</u> (Millions of Dollars)	<u>Corp. Income Tax Liab.</u> (Millions of Dollars)	<u>Tax Liability as % of Profit</u>	<u>Corp. Profits After Tax</u> (Millions of Dollars)
1926	420	34	8.1	386
27	474	38	8.0	436
28	548	45	8.2	503
29	554	48	8.7	506
30	321	40	12.5	281
31	163	33	20.2	130
32	32	32	100.0	-
33	171	37	21.6	134
34	295	52	17.6	243
35	357	65	18.2	292



1936	475	83	17.5	392
37	598	101	16.9	497
38	509	94	18.5	415
39	698	115	16.5	583
40	849	327	38.5	522
41	1,119	510	45.6	609
42	1,305	629	48.2	676
43	1,281	640	50.0	641
44	1,234	598	48.5	636
45	1,244	599	48.2	645
46	1,474	654	44.4	820
47	1,814	702	38.7	1,112
48	1,964	687	35.0	1,277
49	1,879	718	38.2	1,161
50	2,522	983	39.0	1,539
51	2,825	1,416	50.1	1,409
52	2,698	1,384	51.3	1,314
53	2,611	1,220	46.7	1,391
54	2,290	1,082	47.2	1,208
55	2,965	1,272	42.9	1,693
56	3,345	1,413	42.2	1,932
57	3,056	1,337	43.8	1,719
58	3,075	1,315	42.8	1,760
59	3,504	1,581	45.1	1,923
60	3,359	1,562	46.5	1,797
61	3,460	1,612	46.6	1,848
62	3,824	1,750	45.8	2,074

Source: D.B.S. National Accounts (Various Years) "Analysis of Corporation Profits"

It can be seen from Table I how the effective corporate tax rate (tax liabilities as a % of profits) has risen from around 8% in the late 1920's to about 45% at the present time. Apart from an aberration in 1932 when profits virtually disappeared, the pattern of change in the effective tax rate is as follows: Between the late 1920's and the 1930's the rate approximately doubled - during the World War II, the effective rate was tripled to around 48-49%. In the early postwar years, the rate dropped to between 35-39%. It increased sharply to around 50% between 1952-1956, declined to 42% and since then has fluctuated between 43 and 47%.

9. This long period has been subjected to such sharp disturbances that it is difficult to make meaningful comparisons. The following sub periods could be described as somewhat more normal and an attempt will be made to examine changes in corporate profit structure during them, 1926-1929, 1935-1938, 1947-1950 and 1953-62. These periods have been free of war and also free of the worst of the great depression.

Table II	Corp. Profits	Cash Flow	Dividends as % of Profits	Dividends as % of Cash Flow
	After Tax	Before Divid. Dividends		
		(Millions of Dollars)		
1926	386	617	188	48.7
27	436	791	201	46.1
28	503	790	221	43.9



29	506	818	270	53.4	33.0
30	281	590	276	98.2	46.8
31	130	406	247	190.0	60.8
32	-	246	156	-	63.4
33	134	358	167	124.6	46.6
34	243	465	189	77.8	40.6
35	292	514	204	69.8	39.7
36	392	625	243	62.0	38.9
37	497	751	269	54.1	35.8
38	415	672	296	71.3	44.0
39	583	860	302	51.8	35.1
40	522	903	342	65.5	37.9
41	609	1,092	318	52.2	29.1
42	676	1,243	299	44.2	24.0
43	641	1,165	298	46.5	25.6
44	636	1,097	276	43.4	25.2
45	645	1,080	257	39.8	23.8
46	820	1,229	320	39.0	26.0
47	1,112	1,677	467	42.0	27.8
48	1,277	1,957	465	36.4	23.8
49	1,161	1,935	551	47.4	28.5
50	1,539	2,421	762	49.5	31.5
51	1,409	2,319	720	51.1	31.0
52	1,314	2,476	669	50.9	27.0
53	1,391	2,717	634	45.6	23.3
54	1,208	2,703	611	50.6	22.6
55	1,693	3,397	702	41.4	20.7
56	1,932	3,874	767	39.7	19.7
57	1,719	3,925	829	48.2	21.1
58	1,760	3,813	846	48.1	22.2
59	1,923	4,183	894	46.5	21.4
60	1,797	4,227	884	49.2	20.9
61	1,848	4,255	1,026	55.5	24.1
62	2,074	4,602	1,050	50.6	22.8

Source: D.B.S. National Accounts (Various Years) "Analysis of Corporation Profits"

10. Table II compares dividends with profits and cash flow. It can be seen that the pay-out of dividends relative to profits have fluctuated considerably but this is because corporations have attempted to keep their dividends fairly stable when profits were falling.

11. The following sub-table gives the average dividend pay-out rate during the "normal" periods.

	<u>Div. % of Profit</u>	<u>Div. % of Cash Flow</u>
1926-29	48.0	29.2
1935-38	64.3	39.6
1947-50	43.8	27.9
1953-62	47.5	21.9

12. It is striking how little the dividends as a % of profits have changed between 1926-29 and 1953-62, both of which were periods of reasonable prosperity - the tax structure does not appear to have had any effect on the level of dividend pay-out. Dividends as % of cash flow have tended to fall since cash flow has been rising relative to profits. This trend has been a relatively recent development - specifically from the early post war period to the present. It can



be attributed to the more generous depreciation and depletion allowances that now exist. It is interesting to note that the corporations have on the whole retained this additional source of cash rather than passing it on in higher dividends.

13. The following table shows the form in which the corporations have raised capital since 1936:

	<u>Net New Issues (1)</u>			<u>Retained Cash Flow (2)</u>	<u>Direct Foreign Investment (3)</u>
	<u>Corp. Stock</u>	<u>Corp. Bonds</u>	<u>Total</u>		
			<u>Securities</u>		
(Millions of Dollars)					
1936	44	18	62	382	- 62
37	32	2	34	482	- 64
38	9	13	22	376	- 33
39	14	- 25	- 9	558	- 53
40	19	- 71	- 52	561	--
41	--	- 70	- 70	774	--
42	- 3	- 166	- 169	944	--
43	--	- 66	- 66	867	--
44	--	- 43	- 43	821	--
45	25	- 1	24	823	--
46	67	- 8	59	909	40
47	- 2	151	149	1,210	61
48	51	260	311	1,492	71
49	56	170	226	1,384	94
50	116	383	499	1,659	222
51	192	293	485	1,699	309
52	245	378	623	1,807	346
53	237	396	633	2,083	426
54	173	445	618	2,092	392
55	462	322	784	2,695	417
56	689	791	1,480	3,107	583
57	517	950	1,467	3,096	514
58	312	660	972	2,967	420
59	404	104	508	3,289	550
60	220	296	516	3,343	650
61	250	312	562	3,229	515
62	323	400	723	3,552	525

Sources: (1) Bank of Canada Statistical Summary 1962 "Security Issues and Retirements"

(2) Derived from National Accounts "Analysis of Corporation Profits"

N.B. Retained Cash Flow is available for reduction of debt, additions to working capital or capital expenditures

(3) D.B.S. Balance of Payment (Various Issues)

N.B. Not all direct investment would be available to corporations.

14. It can be seen that the retained cash flow dominates the source of funds, being several times the size of all other sources of funds. This has been true since 1936, however, so there is little evidence that the tax structure is of paramount importance in explaining the predominance of cash flow over the capital market.



15. The relationship between corporate stock issues and bond issues is erratic. Here again there is little evidence that the tax structure has affected their relative sizes. However, the yield on common stocks have declined sharply relative to bonds, and some of this changed relationship may be due to the preference of investors for equity and of borrowers for funded debt as described earlier.

## PART II

### (a) The Degree of Competition Within Canada

16. It has been seen how retained cash flow dominates the source of capital funds of Canadian corporations. This has probably had the effect of restricting competition since it reduces the flow of capital available for new enterprises and thus encourages the domination of Canadian industry by large firms which in some cases are undoubtedly growing purely for the sake of size rather than to gain any real benefits of large scale production. However, as was seen earlier, this domination of retained cash flow relative to capital issues is nothing new and there is no reason to suppose that it is the present tax structure which should be blamed substantially for the situation that obtains.

17. Tax adjustments that have the effect of encouraging (or forcing) the corporations to pay out a higher proportion of their cash flow are likely to have the effect of improving both the efficiency and the competitiveness of the Canadian economy since the capital corporations would then have to appeal for funds on the basis of their potential growth and profitability rather than on the basis of their present size. For this reason, proposals such as those submitted by Mr. Capon deserve the most serious consideration. The existence of mutual funds and pension funds with their professional and sophisticated management should result in the more rational reinvestment of funds by the capital market than has sometimes occurred in the past.

18. However, there remains the danger that dividends paid out would not be reinvested but would be partially consumed by the shareholders. Should this be the case, then the slower rate of economic growth resulting from lower investment might outweigh the advantages of a more efficient allocation of the capital that was invested.

### (b) THE INTERNATIONAL COMPETITIVENESS OF CANADA

19. The following table is taken from the study by Ronald Robertson on "Tax Aspects of Canada's International Competitive Position":



International Comparisons of Total Taxes as a percentage  
of GNP, 1960

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<u>Country</u>	<u>Percent</u>
West Germany	34.9
France	33.2
Austria	32.9
Norway	32.1
Sweden	31.3
Finland	30.8
Netherlands	30.1
Luxembourg (1959 figures)	29.1
Italy	28.7
United Kingdom	27.9
United States	27.5
New Zealand	27.5
Denmark	25.1
Canada	24.8
Belgium	24.2
Australia	23.5
Japan	20.2

20. Another 23 countries are also given by Robertson with lower tax to GNP ratios than Canada, however, these can all be described as non-industrial countries.

21. It is interesting to note how low taxes are relative to total production in Canada as compared with most of the other industrial countries. It is also of interest to note that there is no obvious relationship between the rate of economic growth of a country and its tax burden. West Germany and Japan are at opposite ends of the scale with West Germany having a heavy tax structure whereas Japan has a light one, but both of these countries have had fast rates of growth. Belgium has a low tax level whereas France has a heavy one, but France has enjoyed a fast rate of economic growth while Belgium has the lowest growth rate within the European Economic Community. The United Kingdom and Italy have fairly similar tax burdens but the United Kingdom has had a very slow rate of growth whereas Italy has expanded very fast.

22. In general, as far as it is possible to reach a conclusion in as brief a study as this, it appears to us that the crucial factor in the rate of economic growth is the level of investment, either by the private sector or the public sector of the economy, rather than the level of taxation, limited by the tendency of people and capital to flow to the more favourable investment and tax areas.

### PART III

#### THE EFFECT OF THE CORPORATION TAX ON THE TOTAL FLOW OF SAVINGS AND INVESTMENT

23. A careful study of the burden of Canadian taxation has been made by Professor I. J. Goffman for the Canadian Tax Foundation and it is reasonable to accept his conclusions as the best available at this



time. Goffman estimates that 55% of corporate income tax falls on corporate profits, 30% is shifted forward to consumers through higher prices and 15% backwards to wage earners. On the basis of this assumption, Goffman provides the following figures for the effective rates of tax on the various income groups.

<u>Income Group</u>	<u>% of Income</u> (Effective Rate)
Under \$1,000	2.3
\$1,000 to \$2,000	2.5
\$2,000 to \$3,000	2.8
\$3,000 to \$4,000	2.6
\$4,000 to \$5,000	2.5
\$5,000 to \$7,000	2.5
\$7,000 and over	3.2
All Classes	2.8

24. The interesting thing to note here is that the tax is proportional for all but the highest income group. There is little to support the contention that the tax is a burden on the upper income groups alone. It is probable, however, as Goffman points out, that within the \$7,000 and over income bracket the incidence of the tax is progressive, as dividends will constitute a relatively large proportion of the income of this class. Since nearly half the tax is shifted from the corporate profits either on to consumers or wage earners, it is apparent that the double taxation is only partial and this is undoubtedly partly offset by the 20% tax credit on dividends.

25. The incidence of corporate taxes in a self-contained nation would perhaps be immaterial. However, Canada is a trading nation and the incidence of corporate tax levels on corporate profits has to be given serious consideration in relation to our international competitive position.

## CONCLUSIONS

26. Present Canadian tax measures favour debt financing by corporations and produce a desire for equity issues by individuals and many corporations.

27. This may well have created interest rates that are higher and equity yields that are lower than they otherwise would be, without producing a lesser amount of debt offerings or a greater amount of equity offerings.

28. While the corporate tax favours retention of earnings and internal financing the presence of a high rate of retained earnings in periods prior to the high corporate rates suggest that other factors are important. However, in Canada, the presence of high personal rates in conjunction with the absence of a capital gains tax and the presence of a 20% rebate on dividends probably causes the shareholder to accept more willingly the present low payout rates in



relation to Cash Flow.

29. It appears that the present tax structure is not basically inimical to economic development but only because it creates so many forces that tend to nullify each other. This complexity permits tax avoidance, causes waste and hence is inequitable. We draw particular attention to paragraph 5 of the preliminary submission of the Queen's University Study Group dated April 17, 1963.

30. "Tax policy and the rate of potential economic growth. Most of the efforts that go into finding ways to minimize the tax burden of individuals and institutions under the existing system must be regarded as a social waste. The unfrugal behaviour induced by high corporation taxes must also be regarded as largely a social waste. The size of the wastes and whether tax system changes could substantially reduce them are important questions for study."

#### SUMMARY AND RECOMMENDATION

31. In summary it can be said that existing income tax measures have had a "topsy-like" growth over the years, having been changed and amended innumerable times to suit special requirements and circumstances. As a result they are full of ambiguities, conflicts and contradictions. They are cumbersome of understanding and implementation, which in itself makes administration an expensive operation for payee and payor alike.

32. Business and economic conditions have changed drastically in the period since the Income Tax Act was first introduced, but unfortunately the tenor of the Act has not changed with the times and as a result the Act has become more complex. It is recommended, therefore, that these conditions be recognized and faced up to and that bold measures be taken to rid the Act of its many ambiguities and conflicts... indeed it might be better to completely rewrite the present statute and present a new measure dedicated to the concept of simplicity and understandability and which will be more in tune with the present economy of the country.



WITHHOLDING TAXES ON INCOME PAYMENTS  
TO NON-RESIDENTS

INTRODUCTION

1. This section of the brief deals only with taxes withheld from interest or dividends received by non-residents of Canada who are not carrying on business in Canada and who are not employed or rendering services in Canada. It will not deal with rentals paid to non-residents, nor with the question of tax on non-resident corporations doing business in Canada.

HISTORY

2. The Income Tax Act received Royal Assent June 30, 1948, effective January 1, 1949. It continued the analogous sections of the Income War Tax Act and also provided for an income tax of fifteen per centum (15%) on non-residents of Canada upon every amount paid or credited in Canada in respect of dividends and interest as follows:

- (a) upon dividends, irrespective of the currency in which payment is made;
- (b) upon interest payable only in Canadian currency, except upon interest paid on bonds of or guaranteed by the Government of Canada. Interest paid in a foreign currency was exempt and the rate of tax upon interest on bonds of or other obligations of or guaranteed by a province of Canada remained at 5%, if payable solely in Canadian currency.

3. Dividends paid by a wholly-owned subsidiary to a non-resident parent corporation had for many years been taxed at 5% and remained at this rate under the Income Tax Act.

4. The general effect of the legislation adopted as a result of the Budget of December 20, 1960, was to apply a 15% non-resident withholding tax on

- (a) all dividends, including those paid to parent corporations resident in the United States. Dividends paid by Canadian wholly-owned subsidiaries of parent corporations resident in other countries were subject to the maximum existing under tax conventions;
- (b) interest on all bonds and obligations, regardless of the currency in which they were payable, except that where the evidence of indebtedness was issued on or before December 20, 1960, the existing exemption from tax applied to interest on obligations of the



Government of Canada and to interest on obligations payable in a foreign currency. Similarly, the 5% rate continued to apply in respect of interest on provincial obligations which were issued prior to December 21, 1960.

5. Effective March 17, 1961, the 15% withholding tax was also applied on sales to non-residents of Treasury Bills (federal or provincial) issued subsequent to December 20, 1960. The unexpired portion of the difference between the face value of a bill and the average selling price on the date of issue is subject to a non-resident tax of 15% which must be collected and remitted by the Canadian vendor. In order to calculate the tax, the date of issue, maturity date and average selling price on the date of issue is shown on each bill. The amount of interest deemed to have been paid to the non-resident consists of that proportion of the discount at which the bill was originally issued that the number of days to maturity after the bill was sold to the non-resident forms of the total number of days in the term of the bill. If the non-resident sells the bill back to a Canadian resident before maturity, a refund of the tax may be claimed, being the amount attributable to the unexpired portion of the term of the bill. The certificates required in order to claim such refunds from the District Taxation Office to which the vendor originally remitted the tax result in a very cumbersome and onerous procedure, since not only the non-resident vendor, but also the resident purchaser of the bill, must make these certifications in letter form, setting out for them particulars of the date of sale, date of issue, face value, date of maturity, average selling price on the date of issue, the amount of the non-resident tax collected, the Taxation Office to which the tax was originally remitted and the date a new resident purchaser purchased the bill from the non-resident.

6. Bill C - 95, an Act to amend The Income Tax Act, based upon the Budget proposals of June 13, 1963, as revised on July 8, 1963, provides for changes in withholding taxes on dividends, summarized as follows:

- (a) 10% on dividends to non-residents paid after June 13, 1963, by corporations having a degree of Canadian ownership or control;
- (b) 15% on dividends to non-residents, increasing to 20% after December 31, 1964, paid after June 13, 1963, by corporations not having a degree of Canadian ownership or control;
- (c) refunding to non-residents of withholding tax paid in excess of 10% where the payor corpora-



tion has become before January 1, 1967, a corporation having a degree of Canadian ownership and control;

- (d) tax on the income of non-resident-owned investment corporations increased from 15% to 20%; and
- (e) exemption from withholding tax on interest payable on Canadian bonds and debentures issued after June 13, 1963, to non-residents who are exempt from income tax in the countries of which they are resident and who have been issued a certificate of exemption.

For the purposes of the Act, to have a degree of Canadian ownership and control a corporation must throughout the 60-day period immediately preceding a taxation year (i) be a corporation resident in Canada and (ii) either not less than 25% of the issued shares of the voting shares must be owned by Canadians or alternatively the voting shares must be listed on a Canadian stock exchange and it must be established that no one non-resident shareholder owns more than 75% of the shares, alone or in combination with any other person related to him, as defined.

7. Article X of the Canada - U. S. Tax Convention provides that "income derived from sources within one of the contracting States by a religious, scientific, literary, educational or charitable organization of the other contracting State shall be exempt from taxation in the State from which the income is derived if, within the meaning of the laws of both contracting States, such organization would have been exempt from income tax".

#### LIMITATIONS UNDER TAX CONVENTIONS

8. Article XI, para. 1, of the Canada - U. S. Tax Convention provides for a maximum withholding tax of 15% in respect of income (other than earned income) derived by non-residents from sources in the other country. Para. 2 also provided for a maximum 5% tax on dividends paid by a subsidiary company (as defined) to its parent company in the other State. Effective December 21, 1960, Canada acted under Article XXII of the Convention to impose the 15% rate on all dividends paid to parent corporations in the United States, and the United States then automatically increased the rate to 15% on dividends paid to Canadian parent companies by their U. S. subsidiaries. If Canada increases the tax over 15% and terminates the agreement to limit the tax to 15%, the U. S. Revenue Code calls for a 30% withholding tax.

9. The Canada - U. K. Agreement limits Canadian withholding tax to 15% on income (other than earned income) derived from sources



within Canada by a resident of the United Kingdom. Wholly-owned Canadian subsidiaries of U. K. parent companies are not required to withhold any tax on dividends to parent companies provided that not more than 25% of the Canadian subsidiary's gross income is derived from interest and dividends.

10. Withholding taxes on dividends and interest between Sweden and Canada are limited to 15%, with a limit of 5% on dividends from subsidiaries. The same applied to Ireland, Belgium, Norway and Finland. Withholding taxes between Canada and West Germany are limited to 15%.

11. The Agreement between Canada and the Netherlands limits the tax on interest and dividends to 15%. With certain exemptions, the dividends paid by subsidiaries are subject to a tax not exceeding 2½%.

12. Australia and Canada limit tax on dividends to 15%. Apparently the Australian Government does not withhold tax on bond interest.

13. Tax Agreements with other countries can be amended only by mutual consent or terminated by advance notice. It is presumed that Canada is endeavouring to negotiate amendments to those Agreements which provide for maximum rates lower than 15% on Canadian dividends paid to non-resident parent corporations.

#### THE NEED FOR INFLOW OF FOREIGN CAPITAL

14. In the years of greatest expansion in Canada, non-resident security or portfolio investment accounted for a substantial share of the necessary capital for essential major projects -- capital not otherwise readily available from savings, despite the substantial personal savings deposits which Canadians appeared reluctant to invest. Canada, a growing country, will undoubtedly continue to find it necessary to import substantial amounts of foreign capital from time to time to ensure a rate of growth consistent with national objectives.

15. It is conceded that excessive foreign investment has the effect of raising the Canadian dollar to a premium, with a resulting disadvantage to Canadian exporters in foreign markets, but, as long as Canada continues to have a deficit of international payments on current account, some funds must be supplied from foreign sources.

16. To the extent that it is necessary or desirable to import capital from foreign countries, the purchase by foreigners of debt securities should be encouraged, rather than equity investments.



EFFECT OF WITHHOLDING TAXES ON  
INVESTMENT DECISIONS OF FOREIGN INVESTORS

17. When the Government in December, 1960, discouraged the sales of securities abroad by asking provincial and municipal governments to finance in Canada, and when withholding taxes were imposed on new issues of external payment and Canadian Government internal bonds, and the tax on new issues of internal provincial bonds was increased to 15%, there began a substantial decline in the sales of debt securities to foreign investors, especially because of the effect on state and industrial pension funds, savings banks and fraternal organizations. These institutions, trusts and funds pay little or no tax in their countries. The June, 1963, budget provided some relief by exempting them from the 15% tax on any Canadian bonds issued after June 13, 1963, but they are still subject to 15% on interest on internal corporate and municipal bonds issued prior to June 14, 1963, 15% on all bonds issued after December 20, 1960, but prior to June 14, 1963, and 5% on provincial bonds issued prior to December 20, 1960. As a result, the net yield on purchases of these presently outstanding bonds is unattractive to them, not having any domestic tax against which the Canadian withholding tax might be applied as an offset.

18. It should also be pointed out that certain mutual savings banks pay a small rate of income tax and would find it impossible to qualify for a Canadian tax exemption certificate. These banks, because of the reduction in net yield on purchases of new issues after December, 1960, and because of the complexity of the withholding tax structure, lost all interest in Canadian bonds.

19. Foreign investors, both in the United States and especially in other countries, whether or not they are investors able to recover withholding taxes, immediately judge the value of Canadian bonds on their net yield after taxes. It is desirable that some foreign investment be encouraged in Canadian bonds which are payable in foreign currencies. The effect of the present withholding tax on Canadian securities payable in foreign currencies is twofold -- one, it increases the cost to Canadian borrowers (and therefore Canadian taxpayers) and two, it discourages investment interest on the part of potential foreign buyers.

20. It is generally conceded that a healthy interest in Canadian bonds in other countries and an occasional new issue placed in foreign countries has the effect of relieving the pressure on Canadian internal bond prices and is stimulating to the whole Canadian bond market.

21. The withholding tax on Canadian Treasury Bills has discouraged foreign investment in these short-term instruments, not only because of



the tax itself (which can to a large extent be recovered as an offset against the tax otherwise payable), but because of the manner in which it is assessed -- see para. 5, History. The fact that the tax is imposed on bills before the income is earned, and the fact that it is taxed on the unexpired portion of the discount based on the average issue price (rather than the cost to the buyer) creates a most unfavourable reaction on a foreign market in Canadian bills.

#### TAX RATES COULD ENCOURAGE PURCHASES OF DEBT SECURITIES

22. Encouragement would undoubtedly be given to the purchase of Canadian bonds and bills, as well as of prime commercial and finance paper

- (a) if the exemption from withholding taxes provided by the June, 1963, budget to foreign tax-free organizations were extended to include exemptions from tax on interest on bonds issued prior to, as well as after, June 13, 1963.
- (b) if the interest on bonds payable in a foreign currency were exempt from withholding tax.
- (c) if the interest on bonds of or guaranteed by the Government of Canada were exempt from withholding tax.
- (d) if the tax on interest on bonds of or guaranteed by a province of Canada were reduced to 5% if payable in Canadian currency only (and exempt if payable in a foreign currency as well).
- (e) if the tax on interest on bonds or other obligations of or guaranteed by a municipality in Canada were reduced to 5% if payable solely in Canadian currency (and exempt if payable in a foreign currency as well).
- (f) if the exemption from tax were granted to all Canadian federal and provincial treasury bills and short-term paper.

23. If it were attractive to foreign investors of all types and groups to purchase outstanding issues of Canadian bonds, it would have the effect of releasing Canadian funds for the purchase of new Canadian bond issues and of equities.

24. Previous efforts to exempt foreign pension funds and other tax-free organizations from Canadian withholding taxes have never met with a favourable reception by the Government and the tax authorities, on the premise that the Canadian Treasury would lose more in taxes than would the U. S. Government. But it has been established that Canadian pension funds are relatively much larger purchasers of U. S. equities in those industries not otherwise represented in Canada than are U. S. pension funds purchasers of Canadian equities. Conversely, Canadian



pension funds do not to any extent invest in U. S. debt securities. These U. S. funds and institutions would be encouraged to enter the Canadian bond market again if they were not taxed on income from Canadian debt securities.

25. The ultimate removal of the U. S. Interest Equalization Tax is assumed in this brief.

#### WITHHOLDING TAX ON DIVIDENDS

26. It is possible that the U. S. Internal Revenue Code will require a rise to 30% in withholding tax on dividends paid by U. S. corporations to Canadian parent companies and other Canadian shareholders as a result of the increase to 20% in the Canadian withholding taxes on dividends paid to non-residents by Canadian corporations not having a degree of Canadian ownership or control, despite the reduction from 15% to 10% in the case of those which do have the degree of Canadian ownership required. This would work a serious hardship to many Canadian companies with U. S. subsidiaries, as well as to other Canadian investors.

#### RECOMMENDATIONS

27. It is recommended that -

- (a) Section 108 (3a) be repealed and Section 106 of the Income Tax Act be amended to exempt from withholding tax the discount on Canadian Government and provincial treasury bills, and to exempt the interest on short-term finance company notes and commercial paper and notes having a term of one year or less from date of issue to maturity, and that
- (b) Section 106 (1) (b) (iv) of the Income Tax Act be amended by striking out the words "issued after June 13, 1963" to provide exemption from withholding tax on the interest from any Canadian obligations issued at any time to a person to whom a certificate of exemption has been issued under Subsection (9) - i.e., organizations which are not subject to the payment of income tax to the Governments of countries in which they are resident, and that
- (c) Section 106 of the Income Tax Act be amended to provide for a maximum withholding tax of 15% on dividends paid by Canadian corporations to non-residents, retaining the reduced rate of 10% in respect of dividends paid by corporations having a degree of Canadian ownership or control, and that



- (d) Section 110B be amended to reduce to 15% the rate of tax which was increased to 20% by the budget of June, 1963, in respect of non-resident corporations carrying on business in Canada, and that
- (e) Section 105D be repealed, and that
- (f) Section 70 (2) of the Income Tax Act be amended to reduce to 15% the rate of tax which was increased to 20% by the budget of June, 1963, in respect of the taxable income of non-resident-owned investment corporations, and that
- (g) Section 106 of the Income Tax Act be amended to provide for a withholding tax of 15% on bond interest
  - (i) except interest payable in a foreign currency
  - (ii) except interest paid on bonds of or guaranteed by the Government of Canada
  - (iii) except interest on bonds or other obligations of or guaranteed by a province of Canada which should be subject to a 5% tax unless payable in a foreign currency as well as Canadian
  - (iv) except bonds or other obligations of or guaranteed by a municipality in Canada, where the rate should be 5% unless payable in a foreign currency as well as Canadian,and that these rates apply on all bonds or obligations presently outstanding and to be issued.



DEDUCTIBILITY OF FINANCING EXPENSES

INTRODUCTION

1. It is the purpose of this submission to investigate tax practice currently in force in Canada in respect of the cost of raising outside capital for the expansion or re-equipment of Canadian Industry and, if sound rationale is found to do so, to recommend amendments to the existing law.

2. Canadian income tax law, beginning with the "Income War Tax Act" of 1917, has been derived from a combination of United States law and the English system of precedents. Instead of exhaustively enumerating the deductions to be made for the purpose of arriving at taxable net income, as was the practice in the United States, the original Canadian act adopted the English system of declaring that the taxpayer could deduct those expenses necessarily incurred by him in earning his income and left it to the courts to decide what constituted "expenses necessarily incurred". Subsequent revisions of the original act have served mainly to bring into the law the results of such court decisions. With each revision, the areas in the law left open to discretion have been reduced, so as that today we have an Act which provides a tax status for most, but unfortunately not all, business expenses. As the law has become more definitive, thus for practical purposes abandoning the English approach, many expenses of doing business have fallen into a void between the two systems. Despite the fact that our law has yet to be revised sufficiently to encompass all reasonable expenses the courts appear to have adopted the practice of disallowing expenses as deductions because no provision for their deduction exists. This has led to the inequities we shall discuss in this submission.

3. This part of our submission is confined to a discussion of the deductibility of "financial expenses". By financial expenses we refer to payments made as compensation to the owners of capital used or retained in a business and to the costs incurred by a business in obtaining such capital.

4. We will show with reference to specific items that the existing Canadian income tax law with respect to the deductibility of financial expenses is considerably less realistic than that which appears appropriate for the continued growth and development of Canada.

5. For clarity and convenience we have attempted to divide our discussion into several parts, however, because of the interrelationship of the various parts some overlapping occurs.



PROFITS EARNING PROCESS TEST

6. Section 12 (1) of the Income Tax Act contains a general provision with respect to the deductibility of expenses. It states that, "in computing income no deduction shall be made in respect of:

(1) (a) an outlay or expense except to the extent that it was incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,

(1) (c) an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred by the taxpayer for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt."

7. 12 (1) (a), as further qualified by 12 (1) (c), is often referred to as the "profits earning process test". While seemingly straightforward this test of deductibility has been the subject of much litigation. In general, the Courts and the Tax Appeal Board have taken the narrow view, disallowing as deductions under these provisions all expenses other than those which can be directly related to the production of immediate and increased taxable income. This has been carried to the extreme of disallowing expenses shown capable of producing additional profits on the grounds that the expenses were not incurred in the normal day-to-day business of the company. 12 (1) (a) has been used to disallow financial expenses such as in the "Montreal Coke" case where it was held that a sum paid to call bonds for redemption so as to replace them with an equivalent amount of bonds carrying a lower rate of interest was not deductible as to the operation was "totally unconnected with profit earning". This is despite the fact that the operation cut the annual carrying charges of the debt and thus improved the company's profit position.

8. We suggest that the Act does not require or specify that in order to qualify as a deduction, an expense must produce immediate and increased income or that such income must come solely from the day-to-day operations of a business. We suggest that many of the expenses currently disallowed under 12 (1) (a) can reasonably be expected to provide, secure, or maintain profits and therefore meet the requirements of the law if not the current interpretation thereof. Much of the present confusion appears to result from the lack of a definition of what constitutes income. We suggest that the law would be clearer if the words, "for the purpose of maintaining or furthering the taxpayer's business" were used in place of "for the purpose of gaining or producing income". This is not to suggest abandonment of the "profits earning process test", as surely the reason behind



maintaining or furthering a business is found in the profit that is expected therefrom.

9. We would refer to the specific application of 12 (1) (a) and (c) as found in Section 11 (1) (c) of the Income Tax Act. Section 11 (1) (c) states that, "the following amounts may be deducted in computing income of a taxpayer for a taxation year:

an amount paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing his income), pursuant to a legal obligation to pay interest on:

- (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt), or
- (ii) an amount payable for property acquired for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business (other than property the income from which would be exempt),  
or a reasonable amount in respect thereof  
whichever is the lesser;"

10. The more realistic approach to the profits earning process test suggested with reference to 12 (1) (a) is equally applicable to 11 (1) (c). We advocate that interest be allowed as a charge on income providing that the debt or loan is contracted, "in the interest of the business". We feel this approach lends itself to a more realistic interpretation than is possible under the requirement that the borrowing be "for the purpose of earning income from a business".

11. We would question the stipulation that, to be deductible, an interest payment must be in respect of money borrowed to earn taxable income. This reflects the general rule laid down in 12 (1) (c). One of the effects of this provision is that where money borrowed by a corporation is used to purchase shares which generate tax free income, i.e. dividends, in the hands of the borrowing corporation, such interest is not deductible. This is, of course, a very difficult provision to enforce. For example, a company wishing to buy the shares of another company may use its working capital to purchase the shares and borrow money to replenish its working capital. Consequently, this provision discriminates against a company without sufficient working capital to carry-out such a scheme. It could even be said this law places Canadian companies at an unfair disadvantage in competing with



foreign companies in acquiring businesses. We cannot imagine that this provision produces revenue of any consequence and therefore suggest that it be abolished on the grounds that it hinders without just cause the normal conduct of business.

12. We submit that direction should be given to the re-interpretation of the profits earning process test or its amendment so as to eliminate the inequities existing with respect to the tax treatment of financial expenses.

#### FINANCING EXPENSES: ISSUING COSTS

13. Section 11 Subsection (1) paragraph (cb) of the Income Tax Act states that the following amounts may be deducted in computing the income of a taxpayer:

An expense incurred in the year:

- (i) in the course of issuing or selling shares of the Capital stock of the taxpayer, or
- (ii) in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property (other than money used by the taxpayer for the purpose of acquiring property the income from which would be exempt), but not including any amount in respect of,
- (iii) a commission or bonus paid or payable to a person to whom the shares were issued or sold or from whom the money was borrowed, or for or on account of services rendered by a person as a salesman, agent or dealer in securities in the course of issuing or selling the shares or borrowing the money.

14. It has been established under (i) and (ii) of Section 11 (i) (cb), that legal, accounting, and printing costs related to the issuance of shares or incurred in the course of borrowing money may be deducted as on expenses. Also, in some instances where the recapitalization of a company has been necessary as a preliminary step to an issue the expense has been allowed. These sub-sections, introduced in 1954, were a step in the right direction as they take notice of the fact that there are direct expenses involved in the course of obtaining funds. Previously all expenses incurred in the course of borrowing money or obtaining equity capital were held to be capital outlays. On the few occasions the law has been tested it has been narrowly interpreted as evidenced by the case of "St. Laurent vs. M.N.R." where it has held



that money paid to a guarantor of a bank loan was not deductible. The result of this ruling was that the person paying for the guarantee was taxed as was the guarantor.

15. In 1961, additional Sub-Sections, namely 11 (i) (cd) and 11 (i) (ce) were introduced to permit the deduction of certain certification fees such as those paid on non-interest bearing past-dated bills drawn on a bank and payable not more than 90 days from the date of certification. This applies particularly to bankers acceptances. Where a bill of the type described above is sold at a discount the taxpayer is permitted under Section 11 (i) (ce) to deduct as an expense the amount of the discount.

16. Under Section 11 (i) (cc) other expenses such as registrar and transfer agent fees, fees payable for services rendered by a dividend paying agent, stock exchange listing fees and expenses incurred in printing and issuing financial reports to shareholders are permitted as deductions. The majority of the above amendments were introduced with a view to eliminating inequities in the law with respect to the tax treatment of issuing costs, yet at the same time there is included an amendment giving formal status to one of the worst such inequities. We refer to 11 (1) (cb) (iii) which provides in effect that a commission or bonus paid to a purchaser of shares or a lender or for services rendered by a salesman, agent or dealer in securities in the course of issuing shares or borrowing money may not be taken as an expense by the issuer or borrower.

17. Apparently the law takes the position that aside from the expenses specifically permitted as deductions, an outlay for the purpose of raising capital is considered to be a capital outlay, and in particular a capital outlay of the type for which no provision for amortization exists. A most obvious form of double taxation results. A discount is first taxed in the hands of the borrower by virtue of being disallowed as a deduction and then, as the portion of a discount which is retained by the underwriter is in effect a commission taxable in his hands as income, it is taxed again.

18. A commission taken by a dealer in securities, as either an underwriter or an agent, usually takes the form of a discount from the principal amount. This leads to grouping an underwriter's discount or commission with true discounts granted the ultimate purchaser and results in absurdities such as the one found in the method of calculating taxable income under Section 7 (2) of the Income Tax Act. Section 7 (2) provides in effect that where an obligation issued at a discount after December 20, 1960 by a tax-exempt person, corporation or government body carries a coupon of less than 5% and where the yield resulting from the



discount exceeds the coupon by more than  $1/3$ , the amount by which the principal amount of the obligation exceeds the amount for which the obligation was issued shall be included in the income of the first taxable Canadian owner of the obligation. The first taxable Canadian owner of such securities is, in the normal course of distribution, an underwriter and if, the law is applied as read, the whole of the discount at which the security is issued will be income in the underwriter's hands although his profit from the distribution could be a considerably smaller amount, that is if after deducting his commission the underwriter sold the bonds at a discount.

19. Perhaps the best way to illustrate the deficiencies in any law is to show how it may be avoided. In respect of the non-deductibility of an underwriter's spread, avoidance of the ill-effects is in theory relatively simple. For example: We will assume a corporation is contemplating an issue of 20 year  $5\frac{1}{2}\%$  bonds. The underwriter's commission will be 3%. If the bonds are sold to the underwriter at 97 and to the public at 100, the underwriter's spread thus taking the usual form of a discount, the after-tax cost to the issuer, assuming a 50% rate of tax, is approximately 3%. This figure is arrived at by taking the yield or cost to maturity of a  $5\frac{1}{2}\%$  bond at 97, i.e., 5.75% and halving the portion represented by the coupon, i.e. 50% of  $5\frac{1}{2}\%$ . The remaining .25% is not reduced as it represents the cost to maturity of the underwriter's commission which is not deductible for tax purposes. The purchasers of the bonds pay 100 and receive a yield of 5.50% to maturity. If the issuer attaches a coupon of  $5\frac{3}{4}\%$  to the bonds and sells them to an underwriter at 100 who in turn sells them to the public for 103 thus recovering his commission, the after tax cost to the issuer is approximately  $27/8\%$ . That is, the issuer can claim as a deduction the full amount of the annual interest and therefore, the after-tax cost is 50% of  $5\frac{3}{4}\%$ . As the yield to maturity on a bond purchased at 103 with a coupon of  $5\frac{3}{4}\%$  is 5.50%, the purchaser receives exactly the same return on his investment as in the first instance. The only thing which would seem to prevent wide scale adoption of this practice is perhaps the reluctance of the public to buy bonds at a premium.

20. We can only wonder at the reasoning behind excluding an investment dealer's spread from deductible expenses. It seems to us that where payment is made that is taxable in the hands of the recipient, it should be deductible as an expense for the account of the payor, either as a current item or as the result of amortization over a suitable period.

21. We believe it evident that the expenses of raising capital are a part of its true cost, and combine with servicing as a measure of its real price to the capital user.



FINANCING EXPENSES: EFFECT ON THE CONDUCT OF BUSINESS

22. The lack of rationale now present in the law as it relates to financial expenses is reason enough to recommend its revision. Yet, in addition, there is the question of the effect of the existing law on the conduct of business. Canadian industry is to be encouraged to expand so as to create new job opportunities, and is advised to compete more strongly in world markets. It seems to us that any expansion of Canadian industry or improvement in its competitive position will depend to a large degree on new or modernized plant facilities. The removal of unnecessary obstacles to the employment of capital is necessary in encouraging an expansion and upgrading of our productive capacity.

23. It is evident that Canada requires capital for industrial development and therefore, it seems highly questionable to add, through the functioning of the tax laws, to the natural limitations imposed by the market. We submit that the existing law with respect to the tax treatment of financial expenses restricts the choices open to a company contemplating financing, makes financing more expensive than necessary, and limits the opportunities for a company to affect savings in the cost of capital.

24. The following will serve as a specific example of how the existing law operates to limit the opportunities for a company to affect savings in the cost of capital. We will assume that a borrower floated a bond issue having as one of its terms and conditions the right on his part to call the bonds prior to maturity provided he pays accrued interest and a premium over the face amount of the bonds as a penalty and that at some point prior to the maturity of the issue, either because interest rates have declined or the credit rating of the borrower has improved, there develops the possibility of refunding for a savings in rate by borrowing afresh in the market. We will assume: that the original issue consisted of 6% bonds due in 20 years, that the commission paid on issue amounted to 2.7% of the face amount, that at the end of 10 years the possibility for refunding the original issue with a new 20 year issue arises, that the premium stipulated as a penalty for refunding the original issue at the end of ten years is 3% of the face amount and that the commission to be paid for the sale of new issue will be 2.9%. If it can be agreed that a saving in rate of at least  $\frac{1}{4}$  of 1%, or  $\frac{1}{8}$  of 1% after tax, must be accomplished in order to justify the exercise, it then follows that under the existing law the maximum annual coupon rate which the new issue could bear is 5.18%. If at the time of the original issue and also at the time of contemplated refunding the law permitted the deduction as expenses of commissions paid to underwriters and premiums paid on the early retirement of loans, the



company could refund the original issue for a  $\frac{1}{4}$  of 1% saving in rate with a new issue bearing a coupon of 5.54%. It goes without saying that the likelihood of a company having an opportunity to refund its debt would under the latter circumstances be far greater.

25. A more logical interpretation of the law can clear away these obstacles to the employment of capital and consequently promote expansion of industry without any significant reductions in tax revenues.

26. In support of our contention that the law should be revised to eliminate unnecessary obstacles to the employment of capital we would quote from the report of Royal Commission on Canada's Economic Prospects.

"The final condition for the effective operating of the price system that we cited is that non-price barriers to the supplying and obtaining of funds be kept as low as possible".

#### FINANCING EXPENSES: THE LAW IN OTHER COUNTRIES

27. We have advocated that financial expenses and, in particular, discounts on issue, premiums on the repayment of loans, and commissions paid to dealers on the issue of securities, be allowed as deductions in computing a taxpayer's income either in the year the expense is incurred or over a period in relation to the endurance of the benefit. We find on surveying the tax laws in other countries that our position is well supported in practice.

Schedule of the Deductibility of Financial Expenses  
in Other Countries

	Commission Paid to Underwriters or Agents on the issue of:		Discounts on Issue	Premiums on Repay- ment	
	<u>Debt</u>	<u>Equity</u>	<u>Debt</u>	<u>Debt</u>	<u>Interest</u>
Australia	Yes	No	No	No	Yes
Denmark	Yes	No	Yes	Yes	Yes
France	Yes	Yes	Yes	Yes	Yes
Germany	Yes	Yes	Yes	Yes	Yes
Great Britain	No	No	No	No	Yes
Sweden	Yes	No	Yes	Yes	Yes
United States	Yes	No	Yes	Yes	Yes

28. It is noted that as a general rule expenses incurred in the course of issuing shares are not permitted as deductions. We feel that in Canada an argument can be made for allowing the deduction of such expenses on the grounds that an increase in the equity participation by Canadians in Canadian industry is desirable and to allow this to happen companies should be encouraged to do more equity financing.

29. A number of the countries listed on the foregoing schedule have shown more sustained growth of capital formation and investment



than Canada. Their tax systems may well have contributed to their performance.

#### RECOMMENDATIONS

We would make the following recommendations and suggestions:

- (a) Section 12 (1) (a) of the Income Tax Act, as further qualified by 12 (1) (c), and often referred to as the "profits earning process test", should be re-interpreted or amended so as to eliminate the inequities existing with respect to the tax treatment of "financial expenses", i.e. expenses incurred in the course of raising capital.
- (b) The various sections of the Income Tax Act which, in part by regulation and in part by omission, disallow as deductions expenses incurred in the course of obtaining or utilizing funds should be revised. We suggest that all expenses related to raising debt capital, including discounts representing a commission to an underwriter, and/or part of the compensation to a lender, should be allowed as a deduction. In the case of early debt retirement, any unamortized balance should be deductible as of the retirement date.
- (c) If a corporation purchases and retires its indebtedness at a price in excess of the face amount thereof, the excess of the purchase price over the face amount, which in most cases would represent a premium paid as a penalty for early repayment, should be deductible as an expense in the year of occurrence.
- (d) The disallowance for tax purposes of interest on borrowed money employed to acquire assets which give rise to tax exempt income, as provided for under Section 11 (1) (c) of the Income Tax Act, should be eliminated. It is unlikely that this provision produces tax revenues of any consequence as it is difficult and often impossible to trace the use of borrowed funds to a specific purpose. The law, therefore, can be accused of hindering without just cause the normal conduct of business.



SURPLUS DISTRIBUTIONS

1. It would seem that the problems of accumulated surplus distribution first gained prominence with the publication of the report of the Ives Commission in 1945. It was as a result of this report that Part XVlll of The Income War Tax Act was enacted in 1945, which permitted the distribution of pre-1940 surpluses of private companies upon payment of a special tax of from 15% to 33%. As Part XVlll did not provide for any special arrangements for post-1939 surplus accumulations, it is perhaps not surprising that the matter received attention again in 1950, when Section 95A of The 1948 Income Tax Act (now Section 105 of The Income Tax Act) was enacted. This Section permitted companies to distribute pre-1950 surpluses and to distribute further accumulations up to the amount of dividends declared in 1950 and subsequent years upon payment of a special tax of 15% in each case.

2. The original "designated surplus" provisions of the Act were also enacted in 1950 to prevent a change in the form of accumulated surpluses by their movement from one company to another. Since that time a number of new sections have been added to Part 11 of the Act - in 1953, Section 105A, Tax on Premiums Paid on Redemption or Acquisition of Capital Stock; in 1955, Section 105B, Tax in Respect of Dividends Paid out of Designated Surplus; and in 1959, Section 105C, Tax in respect of Undistributed Income after Amalgamation. There have also been a considerable number of amendments to these sections since their enactment, mostly to close loopholes disclosed by the activities of enterprising taxpayers, and culminating in Resolution 16 of the 1963 Budget Resolutions which would give the Minister the power to tax amounts received by a taxpayer which, in the Minister's opinion, have produced an avoidance of tax in consequence of a distribution of income of a corporation.

3. The above brief historical summary shows that no positive action has been taken with regard to the alleviation of problems of surplus distributions since 1950. We feel that it is time that the problems were considered again in the light of the experience of the last thirteen years. The reasons which lead us to make this statement are as follows:

(a) Many private companies pay out little of their earnings in dividends, particularly in their early years of growth, when the earnings are retained in the business to provide capital for expansion. A relatively substantial surplus may be accumulated over a period of



time and 50% of this surplus must be paid out in normal dividends before advantage can be taken of the provisions of Section 105.

(b) With public companies it is a rough rule of thumb that 60% of earnings are paid out in dividends. The remaining 40% is left in the business and over a period of years may accumulate to a very large sum of money. To our knowledge, very few public companies have taken advantage of the provisions of Section 105, perhaps because of the discriminatory effect of the flat 15% rate of tax. With the 20% tax credit, a personal tax rate of 35% would equal the Section 105 rate of 15%. The 35% personal rate is reached with a taxable income of from \$10,000. to \$12,000. Thus shareholders with taxable income of less than \$10,000 are better off with normal dividends, while those with taxable incomes of more than \$12,000 are better off if the company elects under Section 105.

(c) It is natural, in a country with an expanding economy, for companies to grow and, as they grow, for their accumulated surpluses to become bigger. Although a 15% rate of tax on distribution may not seem large the amount of money required to pay it may become very large, and this leads to the development of devious schemes for avoidance of the tax. The Minister's difficulty in keeping ahead of the taxpayer is exemplified in the approach taken by him in the 1963 Budget resolutions.

(d) The existence of an accumulated surplus in a company carries with it the overhanging potential income tax liability on distribution. This liability may be deferred, perhaps indefinitely, but it is always lurking in the background. Assuming again that we will continue to have an active and expanding economy, it is to be expected that the usual corporate changes will continue to occur, that is, that private companies will become public companies, that companies will be bought out by other companies, that mergers or consolidations of companies will take place, etc. In all these corporate manipulations the real or potential income tax liability arising from accumulated surpluses is a deterrent or a hindrance to the consummation of the proposed transactions.

4. The purpose of this submission is to bring to the attention of the Commission our feeling that the problems which exist with regard to accumulated surpluses are real and will probably become worse, and to recommend that the Commission give their full consideration to ways and means of achieving a permanent, long-term solution to these problems.



5. We now turn to a consideration of the manner in which Paragraph 16 of the Budget Resolutions proposes to stop the tax-free distributions of corporate surpluses commonly known as "dividend stripping". In recent years efforts by shareholders to avoid double taxation of corporation profits have taken up an enormous amount of the time and skills of expert lawyers and accountants and their efforts have been to a considerable degree successful. As various "loopholes" were discovered patchwork attempts were made to amend the Income Tax Act to block them. The result has been complexity, confusion and inequity.

6. Section 26 of Bill C-95 presently (October 21, 1963) before Parliament proposes to give to "the Minister" a power to tax sales of shares or other (undefined) transactions if in the opinion of "the Minister" one of the purposes of the transaction was to effect a substantial reduction of assets of a corporation in such a manner that any part of any tax that might otherwise have become payable will be avoided.

7. It is the Association's view that legislation of the type represented by Section 26 is undesirable, both from the standpoint of the business community and from that of the Department of National Revenue. The discretionary powers given the Department of National Revenue places a heavy burden of work on Department officials and forces them to make qualitative judgments. At the same time, the taxpayer is left in an uncertain position until a decision is announced by the Minister. The Association recommends that Section 26 and similar discretionary legislation be redrafted to set forth more precisely the terms and conditions under which taxation is attracted.

8. Dividend stripping in Canada has usually been carried out either by amalgamation or by the sale of shares to persons who can, in effect, receive dividends tax free. The use of amalgamations for dividend stripping can, we submit, be stopped quite simply by defining "designated surplus" in the Income Tax Act to include, for an amalgamated company, the undistributed incomes on hand of its predecessors immediately prior to the amalgamation.

9. The problems of stopping stripping operations by transferring shares to persons who can receive dividends without attracting tax are not so simple and it is not intended to propose detailed solutions here. We suggest they probably can be solved. For example, the familiar manoeuvre of dividing shares into voting and non-voting in order to avoid the intent of Section 105B(1) of the Income Tax Act could, we suggest, be blocked if that section were amended to refer to entitlement to more than half of any dividend instead of the ownership of more than half of the voting shares of the company in question.



10. It appears to us that this problem has been substantially solved in the United Kingdom by the provisions of Section 4 of the Finance (No. 2) Act 1955 as amended by the Finance Act 1958 and by Section 28 of the Finance Act 1960.

11. The first of these provisions precludes, under certain circumstances, dealers in securities from obtaining tax advantage by offsetting losses in share dealings against dividends received out of profits accumulated before the shares in question were acquired and in effect taxes charitable institutions and other tax-exempt persons who similarly lend themselves to stripping operations.

12. The second has a similar purpose but is couched in more general terms and, perhaps, at first glance, appears to give the same sort of powers to the U. K. Commissioners of Internal Revenue as those which, we now suggest, should not be given to the Canadian Minister of National Revenue.

13. The differences are however, in our submission, of fundamental importance. In the first place the U. K. rules are clearly not retroactive. Secondly the taxpayer can avoid their effect by showing "that the transaction or transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments and that none of them had as their main object or one of their main objects, to enable tax advantages to be obtained". Thirdly the circumstances of tax avoidance under which the remedial legislation can be applied against the taxpayer are strictly limited and carefully defined; as opposed to the Canadian Minister's catchall power to tax a payment received one way or another or, in the precise words of the proposed amendment, "otherwise, as a payment that would, but for this provision be exempt income".

14. Lastly, and perhaps most important, the U. K. Act gives an effective right of appeal from the decision of the Commissioners of Internal Revenue to the Special Commissioners, from them again to a special tribunal similar to our Tax Appeal Board and from that tribunal to the High Court.

15. Here, it seems to us, could well be guides to remedial legislation in Canada which could substantially solve the problem from the Government's point of view without denying the taxpayer the right to an impartial hearing on the merits of his case.

16. In any event, we suggest that the Government should make a further attempt to solve this problem by amendments to the Income Tax law which do not give to civil servants a power of decision as to whether a particular transaction shall attract tax or not.



17. Finally, we would submit that if the Government persists in providing an administrative discretion to tax then at least the political and moral responsibility for invoking that power should be placed on the shoulders of more than one individual. Some further protection might be awarded the taxpayer if a group such as the Treasury Board had to share the direct personal responsibility with the Minister of National Revenue.



SECURITY TRANSFER TAXES

1. A tax that plagues investment dealers, stock brokers and investors is the Security Transfer Tax imposed by the Provinces of Ontario and Quebec at the rate of 3¢ per \$100 on corporate and certain other bonds, and an approximately equivalent rate on shares, upon every change of ownership consequent upon the sale, transfer or assignment of a security made or carried into effect in the respective province. An exemption is allowed in the case of the original issue of a security to the first purchaser.

2. First introduced by the Province of Quebec in 1906, the Security Transfer Tax was adopted by the Province of Ontario in 1911 and in 1920 was incorporated in the Special War Revenue Act by the Federal Government. The Federal Government subsequently found that this tax produced an insignificant amount of revenue and it repealed the Dominion Security Transfer Tax in 1953.

3. The Public Accounts of the Provinces of Ontario and Quebec disclose that the Security Transfer Tax is a declining source of revenue when compared on a percentage basis with the total revenues of the Provinces. Taxes from this source for the fiscal year ended March 31, 1962 represented .43% of Ontario's and .24% of Quebec's revenues while the comparable percentages for 1953 were .53% and .32% respectively. While the Security Transfer Taxes have become a decreasing factor in the provincial revenues they have imposed a greater burden on the dealer and investor having increased in Ontario from \$1,846,159 in 1953 to \$3,534,875 in 1962 and in Quebec from \$912,539 in 1953 to \$1,779,445 in 1962.

4. We believe that the original concept of the Security Transfer Tax was that of a single levy on the change of ownership of securities from one investor to another. This concept applies, generally speaking, to transactions in securities listed on a stock exchange where the broker acts as an agent, and one tax is levied against the vendor.

5. In many cases, however, the distribution of securities from the issuer to the investor or from one investor to another does not take the form of a direct sale from one to another, but is effected through one or more security dealers who act as principals in the transactions.

6. The underwriting of new issues of securities and trading in outstanding securities are the main functions of an investment dealer. Through his trading activities the dealer establishes and maintains



markets and thus provides liquidity and establishes value levels for securities not listed on exchanges. In carrying out these functions, the investment dealer is continually subjected to transfer taxes because he acts as a principal, and there is a legal change of ownership involved in his sales. It frequently happens that a security may pass through the hands of two or more dealers before finding its way into the hands of the final investor. Each dealer, acting as a principal, is subject to the payment of a transfer tax on his sale and therefore two or more taxes are collected on a series of transactions which are required to effect a single transfer of ownership from one investor to another.

7. In the case of the primary distribution of a new issue of a security to the public, the distributing machinery generally employed by an underwriter consists of the formation of banking and selling groups of dealers. This gives rise to multiple transfer taxes, being charged first on any change of ownership within the groups and second on sales by each firm to the public.

8. The investment dealer is required to calculate, collect and remit the transfer tax payable by his clients. In cases where the transfer tax is payable by a non-resident of the taxing province, or where the nature of the transaction has made the seller liable for both Ontario and Quebec transfer taxes, it is not always possible, or feasible, for the investment dealer to collect the tax exigible. In such cases the dealer absorbs the tax.

9. We recommend that the Ontario and Quebec Security Transfer Tax Acts be repealed in view of the small amount of revenue produced and as a constructive, if minor, step towards encouraging the purchase of securities by Canadians.

10. If this move is not considered feasible, we would recommend that transactions by investment dealers as vendors be made exempt from transfer taxes.



THE ROLE OF FOREIGN CAPITAL IN CANADA'S  
POSTWAR ECONOMIC DEVELOPMENT

INTRODUCTION

1. In order to arrive at suggestions to assist the Government to achieve its objective of broadening Canadian ownership of productive resources, this brief will review the role of foreign capital in Canada's post-war economic development and show the record on the basis of the latest data available. Special mention will be made in this connection of the implications of foreign investment for the Canadian balance of payments.

2. The brief will also analyse recent Canadian legislation and especially tax measures designed to bring about changes in the ownership and control of Canadian productive resources. A list of specific recommendations will conclude the brief proper.

3. Appendix I will provide a review of Government action aimed at influencing foreign-controlled companies to adopt policies best suited to sound Canadian economic development, while Appendix II will outline regulations which exist in several other countries with regard to non-resident investment.

THE STATISTICAL RECORD

4. One way of looking at the role that non-resident capital has played in the Canadian economy during the postwar period is by relating the net inflow of foreign capital (i.e., the counterpart of the deficit from current international transactions) to such measures of economic activity as new capital investment or total expenditures on goods and services. This type of comparison indicates the extent to which this country has drawn on foreign resources in the process of creating new fixed assets, or more generally, in making goods and services available for current consumption and investment in Canada. The statistical record shows that for the postwar period as a whole, net foreign savings have financed approximately  $9\frac{1}{2}\%$  of total private and public investment (including inventories) and 2% of Gross National Expenditure.

5. Two observations should be made in this connection: First, the broad allegation that foreign savings put at Canada's disposal have gone into non-productive uses, is unfounded. Indeed, the fact that Canada has devoted an exceptionally high proportion of its output to new fixed capital formation throughout the postwar period and that the country's productive capacity has increased substantially is prima facie evidence to the contrary. Second, it is important to distinguish between the volume of foreign capital inflows for the postwar period as a whole and the trend of such capital inflows over this period. Year-



by-year data indicate, in fact, that up to 1956/57, Canada increased her reliance on foreign capital both in absolute and relative terms, whereas in the subsequent period (with the exception of one single year, namely 1959) net capital imports have shown a declining tendency.

6. Another, in many respects more relevant, measure of the contribution that foreign capital has made to Canadian economic growth since World War II, is provided by the concept of direct foreign financing of new private and public investment. This takes into account not only the annual inflows of foreign investment capital, but also the retained earnings and capital cost allowances of non-resident-owned business enterprises in Canada. If this yardstick is applied, the proportion of Canada's gross capital formation financed by non-residents in the postwar period works out to about 28%.

7. The latter comparison underlines the fact that, despite the declining trend in net capital imports, non-residents will continue to play an important role in financing the creation of new productive assets in Canada, if only because such a high proportion of total domestic savings is generated by foreign-controlled corporations.

8. Finally, it is useful to analyse the postwar growth in the various forms of foreign investment. The following table shows a comparison of Canada's international investment position between 1945 and 1961 (the latest year for which such data have been published).

	<u>1945</u>	<u>1961</u>
	(In Billions of Dollars)	
<u>CANADIAN LIABILITIES</u>		
Direct Investment	2.7	13.7
Government and Municipal Bonds	1.7	3.4
Other Long-Term Investments	2.7	6.5
Other (Mainly Short-Term) Liabilities	0.9	4.2
<u>TOTAL</u>	8.0	27.8
<u>CANADIAN ASSETS</u> (Deduct)	4.0	9.9
<u>CANADIAN NET INTERNATIONAL INDEBTEDNESS</u>	4.0	17.9

9. The most striking feature of this table is undoubtedly the large absolute and relative rise in direct investment. Of the \$11.0 billion increase in such investment since the War, about \$4½ billion represents earnings retained by foreign-owned business enterprises operating in Canada.

10. An analysis of the distribution of foreign direct investment reveals heavy concentration in the resource industries (particularly petroleum and mining), although large foreign equity positions have also been built up in many lines of manufacturing.



11. While Canada's gross liabilities are measured at book and not market value, it is interesting to note that, in relative terms, the growth of such liabilities has corresponded closely to that of Gross National Product.

#### INFLUENCE ON ECONOMIC GROWTH

12. Historically, periods of rapid economic growth in Canada have been associated with heavy inflows of foreign capital. Geography, population, resources and other factors have made Canada's economic development dependent on injections of large volumes of capital. At the same time, close relationship with highly industrialized, raw material hungry, capital exporting countries (such as the United Kingdom and later the United States) have provided a logical solution to Canada's needs. In fact, not only have Canadian borrowers been able to satisfy a significant portion of their financial requirements abroad during periods of rapid expansion, but foreign investors have been responsible for initiating and financing directly a great number of industrial and resource projects in Canada. Such direct foreign investment has usually been in response to at least one of three goals: access to the Canadian market (where import tariffs were prohibitive); access to the Commonwealth market (where the preferential tariff system offered sufficient advantages); or the exploitation of Canadian natural resources. This third aspect of foreign investment has either involved manufacturing in Canada and subsequent export of the finished goods, as in the case of newsprint, or, more frequently, shipment abroad of commodities in a semi-processed or primary form, of which iron ore, base metals, petroleum and natural gas are examples.

13. While it would be wrong to assume that in the absence of foreign capital, some of the large resource projects would have never been undertaken or some of the manufacturing industries would have never been created, it is safe to state that such developments would have been retarded or at least carried out on a smaller scale. Thus there can be little doubt that foreign investment has made a major contribution to the rate of growth of the Canadian economy. This is particularly true of the post-war period of economic expansion which culminated in 1956/57.

14. Against these advantages, it is claimed that the degree of foreign ownership of Canadian industry may now be such as to slow down the pace of economic advance. Not only are the annual payments of interest and dividends to non-residents considered to be a major burden on the balance of payments, but it is suggested that the commercial policies of foreign-controlled enterprises militate against the necessary expansion of exports and displacement of imports, especially in the manufacturing area.



15. While the balance of payments implications of foreign investment will be discussed in a later section, it should be emphasized here that such generalizations concerning the export and purchasing policies of foreign-controlled companies have little if any validity. As has been pointed out earlier, a variety of factors (foreign and domestic tariffs, supply sources, etc.) have been responsible for the creation of foreign subsidiary companies in Canada and their policies should be viewed in the light of these factors. Furthermore, it is evident, as will be seen in Appendix I, that Government action, in the form of moral suasion and various incentives, can have a significant positive influence on commercial policies of particular industries.

16. The case against the overwhelming degree of foreign ownership of productive resources rests essentially on the desirability of enabling Canadians to participate in the economic development of their country. This problem will be discussed more fully in later sections.

#### BALANCE OF PAYMENTS IMPLICATIONS

17. The burden arising from foreign investment is generally associated with dividend and interest payments to non-residents. Although these have grown rapidly in the post-war period, from \$312 million in 1946 to \$781 million in 1962, the carrying capacity of the Canadian economy has also expanded. In fact, payments of interest and dividends absorb today the same proportion (i.e.  $9\frac{1}{2}\%$ ) of total receipts from current international transactions as they did in 1946, while in relation to Gross National Product they now represent a somewhat smaller charge than in the early post-war years (1.9% in 1962 as against 2.6% in 1946.)

18. It is true that dividend payments would have increased much more rapidly in the post-war period had foreign subsidiaries not elected to plough back a large portion (i.e., over 50%) of their annual earnings. As long as the investment climate and opportunities, as well as tax factors, in Canada remain comparatively favourable, it is reasonable to assume that these subsidiaries will continue to re-invest a significant proportion of their profits in this country. At the same time, it appears that manufacturing companies selling primarily in the domestic market have traditionally been paying out a larger share of their profits than companies engaged in resource development. As future earnings in the latter group are closely related to export sales, the foreign exchange necessary to finance increased dividend payments abroad will be readily provided.



19. As a general conclusion it may be said that the fact that foreign investment in Canada during the post-war period has been mainly in the form of equity rather than debt capital, has tied the carrying costs of such investment closely to the effective growth of the economy. It may also be stated that exclusive reliance on foreign debt capital would have resulted in a "fixed burden", in the form of interest payments, which the Canadian economy would have been forced to carry regardless of its capacity. Over the very long term, it can be argued, of course, that Canada should reach a stage of development where it will become a net exporter of capital, and in that event, while it would be possible to retire debt held abroad through the natural process of maturity of issues outstanding, it would be difficult to reduce the amount of foreign equity investment in Canada.

#### THE MECHANISM OF ADJUSTMENT

20. Jacob Viner, in his famous analysis of the Canadian balance of payments in the pre-World War I period, developed his thesis on the mechanism of adjustment. In brief, this stated that an autonomous inward movement of capital would expand business activity with a consequent impact on domestic prices which would have the effect of encouraging imports and discouraging exports. (To this was later added the income effects of expanded activity which would work in the same direction). Eventually a new level of equilibrium would be achieved whereby the current account deficit would offset the capital inflow and no net movement of gold would take place. At that time the world was, of course, on a gold standard. Should the capital inflow suddenly cease, there would be a reduction of domestic economic activity and hence in imports; a trade surplus would ensue which would compensate for any servicing of the previous inflow of foreign capital and again an equilibrium would be reached whereby no net gold movement would occur.

21. This mechanism of adjustment was evidently working in Canada's case during the post-war period, even though the country was no longer on the gold standard.

22. Starting in 1950, the inflow of direct investment capital into Canada rose sharply. This was accompanied by an acceleration in the inward movement of other types of capital, forcing Canada to abandon the fixed exchange rate system. This expanded inflow was caused, in part, by a flight of capital from Europe due to fears of communist aggression and from the United States due to fears of inflation. It resulted in an over-expansion of productive capacity and increased imports of capital goods and consumer goods.



23. With the appreciation of the Canadian dollar in exchange markets and the rapid expansion of income in Canada, the balance of merchandise trade, which was in consistent surplus during the early post-war years, changed to sizeable deficits. While, from a balance of payments point of view, this represented the normal adjustment of the merchandise trade account to the growing surplus on capital account, the decline in the autonomous inward movement of capital in the latter part of the fifties was not followed by a similar adjustment in the opposite direction. It appears that a comparatively restrictive monetary policy by keeping Canadian interest rates high relative to those in the United States, maintained the capital inflow (mainly in the form of Canadian borrowing abroad) at levels which were no longer justified by domestic economic conditions. Thus the Canadian dollar continued to command a premium in exchange markets and the merchandise trade account failed to move into a surplus position. In economic terms, Canada remained a net user of foreign resources at a time when a significant part of her own productive resources became idle.

24. It was not until 1961 that a change in monetary policy, accompanied by several other measures, began to alleviate what appeared to be a "chronic payments deficit". It is certainly difficult to avoid the conclusion that during the period 1957-1961 the so-called "shortage of domestic capital" and the balance of payments problem were largely of Canada's own making.

#### REPLACEMENT OF FOREIGN CAPITAL

25. It is important to bear in mind that measures designed to reduce the inward movement of foreign capital, or measures aimed at replacing foreign capital with Canadian capital, would have two immediate effects: one would be on the balance of payments, and the other on the rate of growth of the economy.

26. In the first respect, measures to reduce the inward movement of equity capital would, of course, tend to reduce the foreign capital inflow in total, unless replaced by borrowings. In this event, interest rates would have to be noticeably higher in Canada than in the United States, in order to encourage recourse to the U. S. market, to finance a still significant deficit from current international transactions. It is by no means sure that under such circumstances, and particularly in view of the current uncertainty surrounding Canadian borrowing in the United States, the necessary funds could be raised abroad. A replacement of foreign equity in Canada by Canadian equity implies essentially a repatriation of U. S. capital, which would impose a sizeable additional burden on the balance of payments.



27. The effects on the economy would arise from the need to create a huge merchandise trade surplus to offset the combined deficit on non-merchandise and capital account, as well as from the fact that certain projects which would have been financed by foreign capital would in all likelihood be deferred. In economic terms, this means that on one hand the growth rate would tend to decline, while on the other hand Canada would be forced to make available to non-residents a significant proportion of its current output of goods and services, with a corresponding reduction in living standards.

28. These balance of payments and economic growth problems suggest that Canada would ultimately be forced to resort to foreign exchange control and rigorous economic planning. In order to avoid this, it is felt that any programme to replace foreign capital with Canadian capital would have to be carried out over a sufficiently long period of time and in such a way as to bring about greater inducement to the provision of Canadian equity funds, rather than to actively discourage foreign investment in Canada.

#### CANADIAN POLICIES RELATING TO FOREIGN INVESTMENT

29. The Royal Commission on Canada's Economic Prospects in the mid-fifties carried out an extensive investigation of the role of foreign investment in Canada. At that time there was relatively little concern about developments in Canada's balance of payments, and the Commission devoted its attention mainly to the problem of foreign ownership and control of Canadian industries.

30. Generally speaking, Canadian policy in the early part of the post-war period was one of active encouragement towards foreign capital, while the floating exchange rate system, adopted in late 1950, was expected to exercise "automatic control" over the balance of payments.

31. The Commission, in analysing the growing role of foreign ownership and control in the Canadian economy, shed considerable light on factors underlying this trend. It pointed out, among other things, that Canada's tax laws "constituted a real deterrent to permitting participation by Canadians in foreign-controlled Canadian business." This was so, primarily because Canada's reciprocal tax convention with the United Kingdom exempted dividends paid to U. K. parent companies by their wholly-owned subsidiaries altogether from the 15% withholding tax, while the tax treaty with the United States provided for a reduced (i.e., 5%) rate in the case of Canadian subsidiaries more than 95% U. S. owned. An additional deterrent was the fact that earnings remitted abroad by non-incorporated branches of foreign corporations operating in Canada were not considered dividends and were, therefore, not subject to the withholding tax.



32. The first important changes in policy, prompted essentially by balance of payments considerations, were introduced in the Supplementary Budget of December 20, 1960. The latter provided for a uniform 15% withhold on all dividend payments and extended this tax to repatriated earnings of non-resident corporations carrying on business in Canada. While in accordance with the Canada-U. S. tax treaty this provision automatically eliminated the previously existing rate differential, the situation with regard to U. K. subsidiaries remained unchanged, any modification in the withholding tax having been made subject to re-negotiation under the terms of the Canada-U. K. tax convention.

33. At the same time, the Government imposed a uniform 15% tax rate on all bond interest transfers, regardless of issuer or currency of payment. In retrospect, this measure, which was aimed at discouraging Canadian borrowing abroad, appears to have been of questionable value. It established, in fact, an artificial differential between Canadian and U. S. interest rates, thus lessening the responsiveness of capital movements to monetary policy and depriving Canada of the necessary flexibility in influencing the composition of foreign capital inflows.

34. The Supplementary Budget also signalled the beginning of a conscious effort towards stimulating investment in Canada by Canadians.

35. Measures in this area included:

- a) suppression of the 4% surtax paid by persons with investment income of \$2,500 or more;
- b) a provision, whereby corporations wishing to qualify for reduced taxes applicable to investment companies were required to increase over a period of three years to 75% the share of their gross revenue represented by dividends of taxable Canadian corporations;
- c) the requirement that pension plan trustees, in order to qualify for this exemption, raise over a three year period to 95% the proportion of their investment income derived from Canadian sources.

36. The Government's action in December 1960, aimed primarily at correcting Canada's current account deficit (and attendant loss of production and employment in Canada) by reducing the heavy inflow of foreign capital, was followed by additional measures, incorporated in the 1961-62 budget. The emphasis in this budget was placed on currency depreciation as a means of improving Canada's position in international current account. This policy ultimately led to the abandonment of the floating exchange rate system and the pegging of the Canadian dollar at 92- $\frac{1}{2}$  U. S. cents in May 1962.



37. The 1962-63 budget concentrated on the strengthening of the competitive position of Canadian manufacturers (mainly through tax incentives for increased production), without introducing any further direct measures in relation to the balance of payments or to foreign investment in Canada.

38. The 1963-64 budget, brought down on June 13th, featured two new elements:

- a) a 30% tax was imposed on certain equity sales to non-residents with a view to discouraging take-overs of Canadian corporations by foreign interests; (The tax was subsequently repealed.)
- b) in order to induce foreign subsidiaries operating in Canada to offer equity participation to Canadians, a double system of withholding tax rates was proposed on dividend transfers. At the same time, the ownership criterion was used to establish which companies would benefit from accelerated depreciation. (The qualifying degree with respect to these provisions was modified substantially on July 8th).

39. Both measures represented a significant departure from previous Canadian policy, inasmuch as they were explicitly aimed at containing the expansion of foreign control of Canadian industries, while at the same time exerting pressure on foreign subsidiaries to offer equity participation to Canadians. The 1963-64 budget was, therefore, interpreted as signalling a shift in basic objectives from the balance of payments area to that of ownership of Canadian productive resources.

40. Unfortunately, the measures relating to the withholding tax and depreciation allowance are discriminatory in character: they impose penalties on foreign investors, unless the latter comply with requirements which were not stipulated at the time the investment was made. (It would have been an entirely different matter to warn foreign companies intending to start operations in Canada that they would be subjected to penalties, if they did not offer participation to Canadians within a given period of time.)

41. Apart from creating doubts as to Canada's future policy concerning foreign investment, these measures have raised problems with regard to the country's international payments position. It has been estimated in this connection that if all foreign-controlled companies decided to offer a 25% equity participation to the public Canadians would have to subscribe in excess of \$2 billion. According to the budget provisions this would have to be accomplished by January 1, 1967. If the entire proceeds of such issues were transferred abroad within the same period of time (i.e., 3½ years), this would



impose a massive burden on the Canadian balance of payments. Looked at from another point of view, the channeling of Canadian capital into existing enterprises on such a large scale would obviously diminish the availability of funds for investment in new productive assets, thus reducing the rate of growth of the domestic economy.

42. It should be noted in this connection that the deadline for offering a 25% equity participation seems to have been set without regard to all the circumstances involved. In particular, no allowance has been made for the fact that the record of earnings and dividend payments of certain foreign subsidiaries may not yet be such as to make a stock issue practical. The foreign parent company would thus be penalized by having to sell part of the subsidiary's equity below its real value in order to avoid the penalty of being taxed on the repatriation of future earnings at a discriminatory rate.

43. A further aspect of this matter is the withholding tax which will apply to the transfer of dividends to Canada by Canadian corporations operating in the United States. Unless the Canadian Government succeeds in re-negotiating the tax convention with the United States, the U. S. withholding tax rate applicable to Canadian investors will automatically rise to 30% on January 1, 1965. It is reasonable to assume that for Canadian companies which derive a substantial part of their earnings from operations in the United States, this will constitute a relatively heavier penalty than for the large U. S. corporations for which Canadian earnings are but a fraction of total profit.

44. In summary, it is felt that the measures introduced in the June 13 budget not only represent a departure from previous Canadian policy of non-discrimination towards foreign capital, but may ultimately have adverse consequences for the Canadian economy.



A P P E N D I X IFOREIGN OWNERSHIP AND COMMERCIAL POLICY

1. This section will deal with official action, in the form of moral suasion and incentives, aimed at influencing the commercial policies of non-resident controlled companies. The merits of this approach will be analysed with particular reference to the oil and automobile industries, both largely foreign-owned.

2. It should be pointed out that the fact that such a review has been included in this memorandum in no way represents an implicit concurrence with allegations that the commercial policies (i.e., the export and purchasing policies) of foreign subsidiaries do not correspond with "the national interest" and that those of Canadian controlled companies automatically do.

3. The development of the iron ore industry in Canada will also be discussed in this section. This is an export-oriented industry, created essentially by foreign steel producers anxious to secure raw material sources for their manufacturing operations. It is a prime example of a large-scale resource development where the initiative came from abroad and where a hospitable investment climate, added to favourable economic and technological circumstances, played a decisive role in attracting foreign equity capital.

4. The three industries reviewed in this section have two things in common: they represent massive risk investments of foreign capital in Canadian productive resources and, with proper policy influences, they can contribute in a major way to the improvement of Canada's international payments position.

THE PETROLEUM INDUSTRY

5. Few major industries in Canada contain as large an element of non-resident control as the petroleum industry. According to data published by the Dominion Bureau of Statistics, such control in the oil and gas industry as a whole amounted to 69% at the end of 1961. Since then this proportion may well have increased as a result of the takeover of several large Canadian enterprises by non-resident interests. It may also be noted that foreign control is more pronounced in some segments of the industry (e.g., petroleum refining), than in others (e.g., gas distribution). It is felt, therefore, that the results achieved under the National Oil Policy since early 1961 can provide a fair illustration of the response of a largely foreign-controlled industry to economic objectives set in the "national interest".

6. The problems which the National Oil Policy was called upon to solve date back to the second half of 1957. By that time, the



expansion of Canadian crude oil markets had reached what appeared to be its economic limits, the business recession had begun to curtail severely the growth in petroleum demand in North America, the exceptional export opportunities created by the Suez crisis had vanished and the United States had introduced an oil import programme, initially on a voluntary basis. As a result, crude oil production in Canada declined markedly in the latter part of 1957 and prospects of marketing increasing volumes of domestic crude in the short run appeared dim.

7. Those most affected by the decline in production and the deteriorating market outlook were the independent Canadian producers whose very existence seemed to be threatened due to their exclusive reliance on income from oil production and their limited financial resources. On a more general plane, it was argued that, because actual and prospective demand for domestic crude oil had a significant influence on capital investment as well as on the balance of international payments, a healthy producing industry was essential to the country's economic progress.

8. The Royal Commission on Energy, appointed in October 1957 to study, among other things, the problems of the oil producing industry and to recommend policies which "will best serve the national interest in relation to the export of crude oil and the marketing of crude oil within Canada itself", published its report in July 1959. It recommended:-

- a) that the refining companies concerned take steps to displace in the Ontario market (West of the Ottawa Valley) products supplied from foreign crude with products refined locally from Canadian crude, and
- b) that the Canadian oil industry take action to expand its export markets in the United States.

The Commission estimated that such a programme would result in an increase of about 40% in domestic crude oil production within 18 months, (i.e., by the end of 1960).

9. It was clear that the implementation of the Commission's recommendations would impose substantial hardship in the short run on the refining companies concerned. Not only were they to pay higher prices for their raw material, as more expensive Canadian crude oil was to be substituted for cheaper foreign crude, but the programme required a re-arrangement of supply and distribution lines and the expansion of existing or the construction of new refining facilities, creating in many instances excess refining capacity which would not be utilized for a number of years. The emergence of the latter on a significant scale would, at the same time, by intensifying competition, prevent the companies from recouping their additional costs through



higher selling prices. Nor were the benefits of increased crude oil production expected to fully offset these costs, even though the majority of the companies concerned had substantial producing interests in Western Canada. (It is important to note in this connection that under the producing system in Western Canada, in which crude oil demand is prorated among all producers, there is little incentive for a company, in terms of production profits, to increase its use of domestic crude oil in its refining operations.)

10. While the Commission seemed to have underestimated the adjustment problems faced by the industry, it should be pointed out that its recommendations did coincide with the existing policies of some (including certain foreign-controlled) integrated oil companies. Meanwhile, most of the other companies began to formulate plans to comply with the Commission's suggestions.

11. On February 1st, 1961, the Federal Government proclaimed the National Oil Policy which established crude oil production targets for the industry to be achieved, in essence, through the voluntary implementation of the Royal Commission's recommendations. The statement intimated, however, that the Government would resort, if necessary, to import control to ensure the success of its policy. The active co-operation of practically all companies concerned (almost exclusively foreign-controlled), despite the significant costs involved, has enabled the industry to reach, and in some cases to exceed, the successive production objectives.

12. The increase in domestic crude oil production between 1960 and 1963 has amounted to close to 50%. The displacement of imports and the expansion of exports, underlying this growth, has sharply reduced Canada's deficit on petroleum account over this period. At the same time, the additional income accruing to producers, together with the improved crude oil marketing outlook, has contributed to the maintenance of a high level of new capital investment in the domestic petroleum industry.

#### THE AUTOMOBILE INDUSTRY

13. The car manufacturing industry in Canada is entirely foreign-controlled and Canadian equity participation in the companies concerned is negligible. (In fact, public participation is limited to 23% of the outstanding stock of one company, Ford of Canada. All the other companies are operated as wholly-owned subsidiaries of foreign corporations.)

14. On the other hand, Canadian ownership is widespread in the automotive parts manufacturing business, although several of the large units are foreign-controlled.



15. The development of the Canadian automobile industry has been largely determined by tariff policy. While high Canadian tariffs induced car manufacturers to set up operations in Canada to supply the domestic market, the Commonwealth preferential tariff system, by providing favourable access to certain export markets, acted as a further incentive in the same direction.

16. Between the two World Wars and in the early part of the post-World War II period, Canadian exports of passenger cars and commercial vehicles more than offset imports. On the other hand, imports of car parts rose rapidly after World War II, contributing substantially to the deterioration of Canada's merchandise trade balance. From 1958 on, part imports began to level off, however, as European manufacturers progressively increased their share of the Canadian car market. 1961 signalled the reversal of this trend and a return to the earlier automotive trade pattern, characterized by the large imbalance between exports and imports of car parts.

17. The decline in European imports was due to several factors, the most important ones being: the introduction of the North American "compact car", the change in the basis of valuation of imported cars for duty purposes, and the competitive advantages gained by Canadian manufacturers through devaluation. The import tariff surcharges which were in effect between July 1962 and February 1963 also had a significant restraining influence on car imports. The developments of the last few years made it evident, however, that the major problem was not one of reducing car imports, but of increasing the Canadian content of domestically produced cars, either directly (i.e., through displacement of imports of car parts) or indirectly (i.e., through higher exports of parts).

18. Meanwhile, the Bladen Royal Commission, which submitted its report in mid - 1961, suggested several fundamental measures to expand production in the Canadian automotive industry along these lines. Although the recommendations were not implemented in one move, they became the basis for subsequent Government action aimed at reducing Canada's trade deficit in automotive products.

19. In October 1962, the Federal Government passed an order-in-council, providing for the refund of the 25% duty on imports of automobile engines matched by increased exports of car parts. At the same time, the 25% duty on automatic transmissions, which had previously been waived, was reinstated with the same rebate provisions.

20. A further important step was taken in October of this year, when all imports of automotive products subject to duty were made eligible for rebate to the extent that Canadian car manufacturers increase exports of car parts to their U. S. parent companies.



21. While there may be problems involved in this type of approach towards further improving Canada's merchandise trade position, it is felt that the response of the industry, which is entirely foreign-controlled, has been favourable, on the whole, and that this policy of incentives will in due time yield the desired results.

#### THE IRON ORE INDUSTRY

22. Iron Ore is a prime example of a rapidly growing Canadian resource industry benefiting from foreign capital and market connections. In fact, the large high-grade Canadian orebodies would not have been developed in preference to equally large and rich orebodies elsewhere in the world, if it had not been for the combination of these factors and Canada's generally favourable investment climate.

23. Canadian iron ore has in recent years not only become a major export commodity, but through its increased use in domestic steel-making operations, it has contributed in an important degree to the displacement of imports.

24. From a minor position in 1945, the industry, sparked by developments in the Quebec-Labrador region, has rapidly moved to a position among the first five world producers. Between 1945 and 1962, production increased 24 times, to 27.9 million tons. By far the largest portion of the ore currently produced is exported.

25. By 1965, Canadian iron ore production is expected to reach 40 million tons, representing an increase of 40% over the 1962 level. The entire net gain will come from beneficiated ores (64-68% iron content) and by far the largest part from producers located in the southern end of the Quebec-Labrador iron belt. The new mining operations in this area alone will have a combined capacity in excess of 21 million tons of beneficiated ore. (Of this, the Carol Lake project of the Iron Ore Company will account for 7 million tons, U. S. Steel's Quebec Cartier, 8 million tons, and Wabush Iron, 6 million tons.) These projects, mostly foreign financed, represent massive expenditures: the Carol Lake operation alone will cost \$200 million, the Wabush project about \$250 million and the Quebec Cartier development an estimated \$300 million.

26. From an economic point of view, Canada's advantage lies in the availability of readily beneficiated ores, which are gradually displacing direct shipping ores in steel operations. Steel producers are, in fact, demanding ores with a higher and higher iron content, as well as of a physical structure to further enhance already improved blast furnace production rates. This demand is stemming mainly from technological changes which are being made to increase the efficiency of smelting pig iron at the blast furnace level, but also to some extent, from the need to curtail transportation costs which are



responsible for a significant segment of the price of the delivered ore.

27. In addition to the shift within the world iron ore industry to ores of higher content and of better physical quality, there has also been a second and parallel development. The whole industry is becoming more international in character; the major United States and European as well as Canadian steel producers are now developing jointly high-grade deposits, such as those in the Quebec-Labrador region. As far as Canadian participation is concerned, the Steel Company of Canada and Dominion Foundries and Steel have acquired interests in the Wabush project amounting to 23.5% and 15% respectively. Meanwhile, the Steel Company of Canada has developed the Hilton Mine near Ottawa, while a growing proportion of Algoma Steel's iron ore requirements has recently come from the Algoma Ore Properties. These trends indicate that Canadian steel producers are also relying more and more on domestic ore supplies.

28. As in the case of the petroleum industry, recent developments in the iron ore industry have contributed in a major way to the improvement in Canada's merchandise trade balance. Canada has been helped in this by the presence of suitable ores, proximity to the centres of U. S. steel production, relative political stability and generous tax legislation. These factors have attracted the foreign capital, without which these projects would probably not have been undertaken for a considerable period of time.

## A P P E N D I X    I I

### REGULATIONS IN OTHER COUNTRIES

This section will review regulations concerning foreign investment in a number of industrial countries.

#### GENERAL

1. Until about 1958-59, foreign exchange regulations provided in most European countries a framework within which the domestic authorities were able to control, if they wished to, investment by non-residents. On the whole, however, the problem of those countries through most of the postwar period was not one of excessive capital inflows. Accordingly, official policies tended to encourage, rather than to discourage, foreign investment at home.

2. With the convertibility of the major European currencies and the creation of the European Common Market, foreign capital inflows have become an increasingly important factor in many European countries, both from an economic and monetary point of view, while the need to attract outside capital for balance of payments reasons has clearly



diminished. In fact, several countries have since 1960 experienced at times embarrassing inflows of "hot money" which forced them to adopt measures to deal with this problem.

3. Meanwhile, the dismantling of foreign exchange restrictions has generally led to a complete liberalization of regulations concerning non-resident investment. In a few countries, however, the remaining elements of the exchange control system are, or at least can be, used to exercise a certain degree of influence over foreign investment. In addition, "informal arrangements" exist in some countries which can serve the same purpose.

4. The problems which may arise in the area of non-resident investment have been brought into focus by the debates within the European Economic Community in early 1963. The desirability of exercising some control over inflows of direct investment capital from outside the Community has, been raised on this occasion, although the majority of the member countries has expressed strong objections to any plan involving controls.

#### UNITED KINGDOM

5. Every type of direct investment by non-residents is subject to approval of the Exchange Control authorities in order to qualify for later repatriation. The Exchange Control Act specifically provides that a U. K. resident may not, "without prior permission, take any action which would have the result that the control of a firm or corporation ceases to be held by persons resident in the United Kingdom".

6. No prior authorization is required in case a non-resident wishes to purchase securities on a U. K. stock exchange. Security purchases outside the stock exchanges are subject to permission, however.

7. The extensive foreign exchange regulations in the United Kingdom clearly provide the authorities with a large degree of control over foreign investment, although this is apparently not being used to any significant extent to influence the size and direction of such investment.

#### FRANCE

8. While non-residents may effect various types of investment without any prior approval, the authorization of the Bank of France is specifically required for the following:

- 1) Acquisition of shares in a company not listed on a French stock exchange;
- 2) Acquisition of an existing business;
- 3) Creation of a new business (including a subsidiary);
- 4) Investments in kind (e.g. contribution of equipment).



9. In principle at least, French authorities have thus substantial discretionary power in the field of direct investment by foreigners, the major exception being the acquisition by non-residents of a company's shares listed on a French stock exchange. In this respect, however, the Government has recently re-instated a regulation, whereby large-scale purchases of French stocks by non-residents at prices varying from daily market quotations are subject to prior authorization.

10. In addition, any loan granted by a foreigner to a resident of France which exceeds one million francs, carries interest of more than four per cent and is for a period of over two years, must be approved by the Bank of France. This regulation, which enables the monetary authorities to exercise considerable influence over the flow of foreign funds into French debt securities, is aimed at curbing hot money inflows and controlling capital investment in the domestic economy.

#### GERMANY

11. In the Federal Republic of Germany investment by foreigners is, on the whole, not subject to government regulation. There is a relatively minor area where the central bank exercises an indirect control, namely short-term investment. German banks have, in fact, agreed since late 1960 not to sell money market securities to non-residents or to pay interest on sight deposits held by foreigners. These measures are intended to deal with international hot money flows and not with foreign control of German industry.

#### BELGIUM

12. Non-residents are free to invest in Belgium. The Banking Commission has the right, however, to stop the take-over (by foreign as well as by Belgian interests) of a company listed on a Belgian stock exchange, if the purchase price offered is, in its own view, too low, irrespective of the prevailing market price. The Commission exercises this power as part of its obligation to protect the interest of shareholders.

#### HOLLAND

13. Although capital transfers, both inward and outward, are subject to control, general licenses have been granted by the authorities for most types of capital transaction.

#### ITALY

14. Regulations concerning foreign investment are being continuously liberalized. Under the existing provisions, non-resident investors are only required to open "special accounts" in order to qualify for later repatriation of capital transferred for direct investment.



The contracting of loans from non-residents, however, requires specific authorization from the Ministry of the Treasury.

#### SWITZERLAND

15. Controls in the field of foreign investment are essentially of an indirect or informal character.

16. As a general rule, Swiss corporations have two types of stock outstanding: 1) registered shares, which may only be held by Swiss residents and 2) bearer shares with no voting right attached, which are fully transferable between Swiss residents and foreigners. This practice is clearly intended to prevent non-residents from acquiring control of Swiss corporations.

17. Another arrangement, known as the gentlemen's agreement between the National Bank of Switzerland and the commercial banks, provides that the latter will not permit the use of foreign funds for the purchase of Swiss shares, mortgages and properties. Together with the interest prohibition and withdrawal notice on foreign deposits, this serves primarily the purpose of curbing hot money inflows.

#### SWEDEN

18. Transfers of capital to and from foreign countries require the prior approval of the central bank (Riksbank) under existing foreign exchange regulations. With minor exceptions, the purchase of Swedish securities by foreigners for portfolio investment is not permitted. While the Bank will generally authorize foreign direct investment (i.e. the creation of subsidiary companies or the purchase of a controlling interest in an existing enterprise), it retains full discretionary power in this field.

19. The repatriation of capital, repayment of loans, etc., is also subject to authorization.

#### NORWAY

20. Foreign investment is not subject to restrictions, an exception being the purchase by non-residents of shares in Norwegian companies, which must be approved by the Central Bank (Norges Bank).

#### DENMARK

21. As a general rule, direct investment (i.e., acquisition of a controlling interest in an existing business or establishment of a new enterprise) requires the permission of the Ministry of Commerce. With minor exceptions, Danish securities may not be bought by non-residents for portfolio investment.



THE CANADIAN INCOME TAX ACTGENERAL

1. The Investment Dealers' Association is submitting its comments and recommendations to the Royal Commission on Taxation in three parts. The first part (Sections A to F) and the second part (Section G) dealt with specific problem sections of the income tax structure where the specialized knowledge and experience of the Association's members could be drawn on to offer constructive suggestions to the Commission. It became obvious in the course of the Association's consideration of these problem areas, however, that the various elements in the tax structure were so closely connected and the effects of specific provisions so inter-related with the effects of others that a general review of the whole taxation system was a necessary preliminary to the development of any complete conclusions. The decision to undertake such a study and to look a little more deeply into the basic tax structure as it affects those aspects of the Canadian economy with which the Association is most familiar was precipitated by a request from the Commission's research director for the Association's views on the following questions:

1. The implications of a capital gains tax.
2. Factors affecting the investment by Canadians in equities.
3. Factors affecting the composition of foreign investment in Canada.
4. Possible ways of encouraging equity investment by Canadians without discouraging foreign investment.
5. The effect of government taxation and budgetary policy on foreign and domestic investment through its impact on investor confidence.

2. These questions, with their wide implications, obviously could not be answered without a much broader look at the whole tax structure. It was, therefore, decided to extend the original scope of the Association's study to take into account some of the more basic problems. These are discussed in this Section.

3. Sections A through G set out recommendations on those specific problem areas to which the Association first gave its attention. It is recognized that some of these problems will be reduced in significance or eliminated entirely if the general proposals in Section H are adopted. It is also recognized, however, that general changes in the tax structure of the magnitude proposed in Section H may not be readily accepted or rapidly implemented and are, therefore, somewhat in the nature of alternatives. If the present tax structure is retained, the minor reforms and reorganiza-



tions set out in Sections A - G are recommended. If a general change in structure such as is proposed in Section H is undertaken, many of the changes suggested in Sections A - G will no longer be relevant in their present form, although the underlying objectives - the elimination of the specific inequities or distortions complained of - will still be desirable, and should still be kept in mind in any reorganization of the tax structure as a whole.

## INTRODUCTION AND OUTLINE

4. This part of the Brief deals with the general questions relating to the effect of Canadian tax policy on investment in Canadian economic development. Although much of the discussion is related to the questions asked by the Commission's research director in his letter of June 25, 1963 (see above) the discussion covers somewhat more ground than the questions posed since consideration has been given to a number of other aspects of the Canadian investment climate. It is the opinion of the Association that the present Canadian tax structure is inhibiting economic development in a number of ways and that accelerated investment in Canadian industry cannot be encouraged effectively until some of these unsatisfactory features of the present system have been substantially altered.

5. In the succeeding sections of this part, the distortions in the Canadian investment situation are discussed, the relationship of the present tax structure to these distortions is analysed, and some proposals for alleviating them are outlined. The sub-sections are set out as follows:

### Pages

H - 3 to 5	Distortions in the Canadian investment market.
H - 5	Defects in the Canadian tax structure -
H - 5 to 6	(a) Excessive complexity of the tax laws
H - 6 to 8	(b) Excessively high rates of tax
H - 8 to 9	(c) Excessive progression in personal tax
H - 9 to 12	(d) The corporation tax
H - 12 to 13	(e) Estate taxes and succession duties
H - 13 to 16	(f) The confused position of capital gains
H - 16 to 20	Proposals for reform - a <u>new</u> income tax act.
H - 20 to 24	Comments and illustrations.
H - 24 to 26	Transitional problems and special cases.
H - 26 to 32	Conclusions and answers to the Commission's questions.



DISTORTIONS IN THE CANADIAN INVESTMENT MARKET

6. Although the Canadian investment market is one of the most active in the world, there are signs that it is not fulfilling its basic purpose as well as it might. For example, it is difficult to find funds for new industrial development, yet investment opportunities appear to be so limited that prices of equity securities are forced up beyond reasonable levels; Canadian securities seem to be so unattractive that a large portion of Canadian savings find more satisfactory investment outlets in the United States or elsewhere, yet established Canadian companies are constantly being sold out to foreign investors.

7. The reasons for this less than satisfactory state of affairs are numerous and complex - far too much so to be dealt with in any detail in a study such as this. It is our conviction, however, that the Canadian tax structure is one of the factors contributing to this unfavourable situation and that certain changes in the tax structure would remedy some of the defects and encourage the development of a Canadian securities market more adequate for its task of financing the economic development of the country.

8. The Association is also convinced that there are other features in the Canadian tax structure which are more directly inhibiting the development of the Canadian economy by diverting effort into unproductive channels and encouraging a less than optimum allocation of resources.

9. Two of the more specific defects in the Canadian securities markets which appear to be directly related to the tax structure are the thinness of the equity market (supply and demand) and the irrational relationship which exists between yields on equity securities and debt securities. Since these conditions seem to be to a large extent due to the advantage which our present tax laws give to debt financing as compared to equity financing and the encouragement which they give to the retention and reinvestment of corporate earnings, it is suggested that a large part of the present dissatisfaction could be alleviated if the tax laws were changed to correct these faults.

10. The distortions in the economic allocation of resources arise to a considerable extent from the same causes. The practice of reinvesting a substantial portion of corporate earnings tends, in the opinion of the Association, to direct a substantial supply of savings into projects which (because they have not been subjected to the test of market acceptability) may not be the most desirable from the point of view of the economy as a whole.

11. Undoubtedly many of the uses made of retained earnings are wise from the point of view of the Company and of the economy as a whole. It does seem probable, however, that the continuous evaluation of alterna-



tives by intelligent and knowledgeable investors which the market could provide, would, in the long run, result in a more effective and rational allocation of resources. Business managements, although qualified and skilled in their own areas, are not usually qualified to look at the investment opportunities of the economy as a whole and their decisions, as a result, may be less appropriate than those dictated by the market.

12. There are many cases, however, where the internal investments chosen by the company, although the most profitable for the company, would not be so if it were not for the tax penalty imposed on funds distributed in dividends for investment elsewhere. Whenever this situation arises a clear misallocation of resources occurs and the economy is poorer as a result.

13. The retention of earnings in corporations and the resultant pressure to expand facilities also contributes to the concentration of economic activity through the outright purchase of competitors or of associated enterprises. Increasing concentration of industrial activity has serious disadvantages from the point of view of the maintenance of a viable competitive economy and, in the circumstances of the Canadian economy, it also has a tendency to increase foreign ownership and control - especially in those industries in which a significant part of the activity is already under the control of foreign companies.

14. The factors encouraging corporate retention of earnings apply with particular force to small, closely-held companies and in these cases the consequences are extremely serious. The position in which the shareholder-managers of such companies are placed by the potential tax burden imposed on the distribution of retained earnings by the combination of income and estate taxes practically forces the sale of the business on the death of one or more of the principal shareholders or in connection with estate planning arrangements in contemplation of such deaths. Under the present Canadian tax structure, the most favoured buyers of small companies in this position are those who can avoid distribution of retained earnings - chiefly publicly held companies or non-residents. The former, being able to make use of the accumulated assets within the business, do not need to face the possibility of paying tax on liquidation; the latter, by reason of residence in another tax jurisdiction, do not have to pay any Canadian tax on liquidation except for a small non-resident withholding tax and they may, by virtue of the different tax structure in their own jurisdictions, be able to avoid payment of any significant amount of taxes at all.

15. In this way, the present Canadian tax structure, by favouring the sale of small companies to large companies or to non-residents, tends to discourage the continuation of independent units and to favour concentration.



16. In the succeeding sections of this Brief, those defects in the present tax structure which seem to contribute to the distortions in the Canadian securities market and to the less than optimum allocation of economic resources are considered and certain proposals for reform are put forward.

#### DEFECTS IN THE PRESENT TAX STRUCTURE

17. The principal defects in the present tax structure as they affect economic activity and especially the financing of new development or the extension of existing development are discussed in this section under a number of headings.

##### (a) EXCESSIVE COMPLEXITY OF THE TAX LAWS

18. The present Canadian tax structure is unnecessarily complex. Innumerable provisions designed to give special concessions to some groups of taxpayers have been succeeded by additional provisions to prevent the extension of these privileges to those not entitled to them and, often, to offer similar privileges to some of those excluded. As taxpayer ingenuity has led to the development of tax avoidance procedures, further provisions have been added to close the "loopholes" and these in turn have led to further attempts at tax avoidance and further refinements in the law. The result is an almost incomprehensible conglomeration of special rules and exemptions which can be understood only by full time tax experts.

19. Most of the complexities in our present tax laws appear to arise from the following features of the system:

- (i) the double taxation (real or apparent) of corporate income;
- (ii) the extreme progression in the personal tax rates;
- (iii) the exemption from tax of certain classes of income; and
- (iv) the use of taxation as a means of controlling or directing economic activity.

20. These elements, because they provide different tax treatment for essentially similar transactions, are inevitably surrounded by a web of definitions, exceptions and special provisions and thus they contribute to the volume of detailed provisions complained of.

21. The increasing complexity of the tax laws is undesirable for a number of reasons. It tends to encourage the adoption of business procedures which conform to the tax favoured activities and to encourage corporate re-organizations and re-arrangements which have for their main purpose the development of a favourable tax position. It inculcates a feeling of frustration and a fear of inadvertently attracting tax which encourages management to devote an inordinate amount of time to the



consideration of tax problems and an excessive amount of money to the hiring of consultants. This results in a loss to the economy of a great deal of effort by skilled and capable managers, lawyers, accountants and tax experts - effort, which can ill be spared from more productive work. It also tends to bring the whole tax system into disrepute by destroying the general faith in its essential equity and thus encouraging the development of a cynical attitude towards the civic duty of supporting the state.

22. Anything which will reduce complexity, and thus eliminate the chances of successful evasion with the consequent waste of productive effort and decline in public morality will, therefore, inevitably benefit the country and its economic development.

(b) EXCESSIVELY HIGH RATES OF TAX

23. The present extremely high rates of income tax for both individuals and corporations have a number of deleterious effects. Some of the more significant of these are set out below:

- (i) High rates are probably a strong disincentive to additional personal effort. When income tax rates approach or exceed 50%, the net additional rewards from extra work begin to compare unfavourably with the alternative of not working so that the temptation to choose untaxed leisure rather than additional taxed income becomes very great. The exact point at which the balance turns in favour of leisure depends, of course, on the general climate of opinion and on subjective value judgements. However, the psychological effect of the half-way mark seems to be quite noticeable and the tendency to avoid tax by avoiding taxable income becomes intensified as the tax rate approaches or exceeds 50%.
- (ii) High tax rates tend to encourage business spending on "frills" - non-essential services to customers, public service expenditures, and so on, - at the expense of productive effort or investment. This tendency arises because such expenditures, unless completely unrelated to the business, are tax deductible, and the feeling that "the Government is paying half" encourages waste and inefficiency.

The tax deductibility of expenditures is not, of course, relevant to the making of choices between alternative investments or expenditures which are equally productive and equally tax deductible. It does, however, affect and distort marginal expenditures, especially choices between current and capital items. This happens because the "opportunity cost" (the value of the alternative



goods available) of a tax deductible expenditure is only a fraction of the amount of earnings or income foregone by the owners of the enterprise. Because the deductibility of current expenditures is assured immediately regardless of the actual productive value of the expenditure, whereas the deductibility of unsuccessful or only marginally successful capital expenditures is delayed and may not be allowed, management choice may tend to be biased in favour of current expenditures on such intangibles as goodwill, public relations, etc. as against investment in productive capital equipment;

- (iii) For reasons similar to the above, high taxes tend to encourage expenditures on employee fringe benefits - the use of company cars, club memberships, group insurance and pension schemes, as well as the various types of "expense account living", rather than on salary increases which would be taxable.

Employees, especially in the higher tax brackets, tend to prefer such benefits, which, because they are non-taxable, are worth far more to them than equivalent amounts of salary. Since the taxable income of the business is reduced by the deduction of payments made for benefits which are the equivalent of salary without any offsetting increase in the employee's income, the obvious loser from this practice is the government but there may be a net loss to the economy as well. This will occur if the granting of employee benefits results in a diversion of resources into activities or facilities which would not be considered desirable by the recipients if they had to pay for them themselves.

The most serious cases of this type of distortion are likely to occur in small, closely-held companies where the position of owner-manager makes this kind of benefit especially attractive. Publicly-owned companies are not, however, immune to such temptations and the total effect of all the uneconomic choices may be significant.

- (iv) When the level of taxation is such that the return from effort devoted to tax reduction becomes attractive, a substantial amount of management effort is diverted to basically unproductive activity - the development of tax avoidance or evasion schemes. In a period when the scarcity of persons capable of filling responsible



positions at all levels of management is recognized as a serious threat to economic development, such a diversion of able and intelligent managers, lawyers and accountants into essentially non-productive activity cannot be viewed with equanimity. It is, of course, difficult to say at what level this diversion actually takes place but it seems to become significant even at levels of taxation lower than those at present in effect in Canada.

- (v) Since it is only when taxes are relatively high that a tax reduction will provide an effective incentive for specially favoured activities or that special relief provisions will be required, it must be recognized that much of the undesirable complexity in our income tax structure is, in itself, the result of high taxes.
- (vi) Another significant effect of high taxes on personal income is their tendency to discourage the distribution of corporate income to shareholders. High income taxes are not the only cause of corporate retentions - other features of the tax structure and of our economic organization are also influential - but the other pressures are intensified as the rates of tax payable on the distribution of corporate income increases. High rates of personal tax payable by shareholders on distributions from corporations are often a contributing factor to the unnecessary retention of earnings within corporations.

(c) EXCESSIVE PROGRESSION IN PERSONAL TAX

24. An excessive progression in the personal tax rates which raises the marginal tax on higher income to levels as high as 80% produces a number of adverse results:

- (i) The steep graduation in personal tax rates tends to reduce the amounts of income available for savings. We believe that those in the higher income groups have a greater propensity to save than those in the lower groups. The removal by taxation of a larger proportion of the marginal income of the higher income groups will produce a more than proportionate reduction in the amount of funds available for investment.
- (ii) Highly progressive personal tax rates make it extremely expensive to distribute corporate earnings once these have been retained. As with any irregular or lump sum payments the graduated tax structure imposes a



heavier burden on income taken in one year than is imposed on the same amount taken over a period of years. High progressive rates of personal taxation thus not only encourage the retention of earnings in corporations in the first place but also make it extremely difficult for such earnings to be withdrawn subsequently. This problem is especially serious in the case of small, shareholder-managed companies where the potential taxes on earnings, accumulated to finance the expansion of the businesses at a time when it was not sufficiently well developed to be able to raise equity funds in the market, become so great that distribution is impossible.

This problem has been recognized several times in the period in which the Canadian Income Tax Act has been in effect but it has not been permanently resolved nor can it be resolved as long as corporate distributions are subject to progressive graduated personal rates which impose a heavier burden on distributions of earnings previously accumulated than would have been imposed on such earnings if they had been distributed as earned.

#### (d) THE CORPORATION TAX

25. The corporation tax in its present form has a number of characteristics which adversely affect the operation of the economy. Some of the major unfavourable features are the following:

- (i) Since taxes are, in the final analysis, payable only by people, a tax imposed on corporate earnings is, in fact if not in form, an indirect tax. There is no objection to indirect taxes as long as their ultimate incidence is reasonably clear and equitable since for many Government purposes, the imposition of taxes on the consumers of goods and services is most easily accomplished by an indirect tax at some stage of the distribution process. The corporation tax, however, is an indirect tax of the least satisfactory type because it is uncertain in its incidence and its burden falls on different classes of investors and consumers in an irregular and capricious manner:

- (a) To the extent that the corporation tax is shifted to customers it becomes, in effect, an excise or sales tax - a sales tax, moreover, which is not neutral in its incidence but, on the contrary, very



unequal in the burden which it imposes on the products of the different industries. It falls more heavily on the products of businesses which have a greater margin of profit in relation to sales and thus artificially encourages the output of those industries in which the profit margin is lower than average and discourages the sale of the products of industries or companies with a higher than normal profit margin. It is hard to see any justification for discrimination against these industries since, in most cases, a higher than average ratio of profits to sales reflects only a relatively high level of plant investment or a less than average reliance on debt financing, neither of which seems to warrant deliberate discouragement. On the contrary, in a developing country it is desirable to encourage capital-intensive industries at the expense of low-capital, labour-intensive industries and to alleviate the position of those industries which have difficulty in obtaining debt financing because they are engaged in new, experimental, and risky activities. The portion of the corporation tax which is shifted, therefore, appears to have an effect exactly opposite to that required of a tax system in a country in Canada's position.

- (b) To the extent that the corporation tax falls on the shareholder, it provides an extra penalty for carrying on business in the corporate form. This, in itself, might not be serious in view of the real advantages of the corporate form for carrying on large scale activities. Its effect may be significant, however, in those industries where there are large numbers of small unincorporated enterprises and where the price and profit structures have been geared to relatively low personal rates of tax. In such cases, the possible economies of scale which may be theoretically possible from consolidation and enlargement of individual enterprises may be offset by the extra tax burden imposed on the corporations which would be required to operate the resulting larger businesses.



As a result, the trend towards larger scale activity which appears to be economically desirable will be discouraged by the tax structure.

- (c) Shifted or unshifted, the corporation tax, being a tax on profits, bears more heavily on profitable companies than on unprofitable ones. It thus tends to penalize the efficient and support the relatively inefficient - a procedure which seems to be contrary to the best interests of the economy as a whole.
  - (ii) The corporation tax may also serve to encourage uneconomic activity because of the different treatment which it, in combination with the dividend tax credit and the personal tax structure, metes out to shareholders in different situations. The effective tax burden on the income received by a small portfolio investor in a large public company is, for example, quite different from that applicable to a major shareholder in a closely held small company. Although the law applying to both is the same, the combined application of the two-stage graduation of corporation tax, the dividend credit, and the graduated personal tax can lead to a wide discrepancy in the proportion of corporate income actually received by the shareholder. The net tax burden borne by low income and high income shareholders in the same company also varies greatly because of the erratic effects of the dividend credit.
- These differences in the effect of the tax motivate various groups of shareholders in different ways and lead to re-organizations and changes in business forms and activities which may differ from those most desirable from the point of view of the economy as a whole.
- (iii) The present deduction of bond interest from income subject to corporation tax greatly encourages debt financing at the expense of equity financing. Debt financing is less flexible and its excessive use is dangerous.



Since debt securities are generally more readily saleable by companies with established earnings records engaged in relatively stable industries, the existence of this bias in favour of debt financing tends to encourage the development of businesses engaged in stable established fields at the expense of those engaged in innovation and risky development projects.

This encouragement to debt financing (which at present tax levels makes a 6% bond no more costly to the borrower than a 3% preferred share) has a tendency to increase the relative supply of bonds on the capital market and thus to distort the relationship between yields on debt and on equity securities. As pointed out above, this distortion in yields, combined with the relative scarcity of equity offerings, is one of the factors inhibiting the development of a fully effective Canadian securities market.

- (iv) By making debt financing relatively cheap, and discouraging the sale of equities, the corporation tax in its present form also favours the perpetuation of close control and of control by non-residents. It thus contributes to the undesirable concentration of economic activity.
- (v) The two-stage graduation in the corporate rate is determined by the income of the company and not that of its shareholders so that the total tax burden borne by the low income shareholders of large companies is often greater than that borne by high income shareholders whose holdings are in shares of smaller companies.
- (vi) The dividend credit - designed to reduce the inequities between corporate and non-corporate earnings - does not achieve the effect intended. It does not take into account the two-stage graduation of the corporate tax rate nor the variations in total income and marginal tax rate of shareholders and, as a result, it is most erratic in its effects. It recaptures most of the corporation tax paid on



the first \$35,000 of corporate income and thus places the shareholders of a small company approximately on a par with the proprietors of an unincorporated business. It does not, however, remove the burden of the extra corporate tax paid by companies earning over \$35,000 so that the sole shareholder of a company earning \$35,000 is better off than the 2 shareholders of a company earning \$70,000 or the 3 shareholders of a company earning \$105,000 and so on.

It also seems to benefit the taxpayers who are in the high personal brackets more than those paying lower rates. This result occurs because the same credit is allowed to all taxpayers no matter how large or small their income, while the before-tax equivalent of a given increase in after-tax income becomes larger as the rate of tax increases. For example, the \$200 reduction in tax allowed to all individual taxpayers receiving a dividend of \$1,000 is equivalent to another \$500 of non-dividend income to a recipient taxed at 60% but is only worth \$285 to a recipient taxed at 30%. \*

\* This is illustrated by the following calculation:

	<u>Taxpayer A (60%)</u>	<u>Taxpayer B (30%)</u>
Dividend income (a)	\$1,000	\$1,000
Tax payable	\$600	\$300
Dividend credit	<u>200</u>	<u>200</u>
Income after tax	<u>\$ 600</u>	<u>\$ 900</u>
Equivalent income from bonds (b)	\$1,500	\$1,285
Tax payable	<u>900</u>	<u>385</u>
Income after tax	<u>\$ 600</u>	<u>\$ 900</u>
Amount of other income equivalent to credit (b - a)	<u>\$ 500</u>	<u>\$ 285</u>

#### (e) ESTATE TAXES AND SUCCESSION DUTIES

26. Although estate taxes and succession duties are unrelated to the income tax structure, the presence of such taxes in our revenue system tends to accentuate some of the Canadian economic problems previously discussed. It does this by adding one more burden to the owners of shares in closely held companies and other relatively non-liquid investments. Death duties are payable in cash, and the beneficiary who receives unlisted shares in a privately held company is in a difficult position if he has no outside resources. He cannot realize and withdraw any of the company's assets except by payment of the confiscatory rates of personal tax imposed on such lump sum withdrawals. Because minority holdings in private companies are not attractive invest-



ments he is unlikely to be able to find a buyer for a part of his shares. As a result he is likely to be forced to sell all of his holding and even to get other shareholders to join him in order to offer a controlling interest.

27. Since other private investors are unlikely to be willing to buy themselves into a future repetition of the same problem, the usual purchaser is an established company, resident or non-resident. Estate taxes must therefore be recognized as one of the factors contributing to the concentration of industry in the hands of large corporations - especially non-resident ones.

(f) THE CONFUSING AND MISUNDERSTOOD POSITION OF "CAPITAL GAINS"

28. (i) The problem of definition:

A large part of the confusion regarding the position of "capital gains" results from the general failure - both in popular usage and in the courts - to distinguish properly between the different classes of income described by this term. The term "capital gain" means, strictly speaking, a gain realized on the sale of a "capital asset" - an asset acquired and held for its income producing potentiality and not for sale or use in the normal course of business. Popular usage, however, includes under the general designation of "capital gain" not only such miscellaneous receipts as windfalls, gambling winnings, etc., but also profits earned on the sale of those kinds of assets (securities, real estate and so on) which because of their nature will become capital assets or investments in the hands of their purchasers. The failure to distinguish between these three elements, all loosely called "capital gains", is responsible for a good deal of the confusion that usually envelopes any discussion of this topic.

The Association is concerned in this Brief only with one of these elements - the profits realized on the sale of investments. It does not propose to deal with the position of windfall or gambling profits as these are not really relevant to the problems of economic development which are the main concern of this submission. Similarly, it does not question the taxability of profits made by its members in the normal course of their operations as dealers in securities. It is concerned, however, with the tax treatment of what might be called true capital gains and of profits realized on the sale of securities and other similar "capital type" assets. In order to avoid confusion



to tax when earned or distributed because securities will sell, in effect, at their after tax value, and the imposition of a tax on increases in value due to these factors before the profits involved have been earned or distributed will, therefore, be inequitable.

It may at first be difficult to accept this idea because our present tax structure is so distorted that different taxpayers can pay widely varying amounts of tax on similar distributions with the result that the natural relationship between retained earnings and market values is obscured. However, careful analysis will show that, other things being equal, the retention of earnings in a corporation will increase the value of its shares by an amount equal to the earnings retained minus the taxes payable by the shareholder on ultimate distribution. As this amount will (in the absence of steep progression, tax credits, and other distorting factors) be the same for present and prospective shareholders, the market price will increase by an equivalent amount. Further reflection will show that an increase in prospective future earnings (goodwill) will have the same effect on market price for the same reasons. From this it is clear that the vendor of shares in such a company, by receiving only the after tax value of retained past earnings or prospective future earnings, has the tax, in effect, deducted from his sale price and that the imposition of a further tax on the net proceeds would be unwarranted and unjust.

With respect to the remaining elements of investment profit, - resource development, technological change, or urban expansion - the arguments for their exclusion from income are both equitable and practical. They are:

1. When personal income is taxed at progressive rates, and an investor sells in one year an investment which has increased in value over several years he is required to pay a higher tax than would otherwise have been the case. Equity, therefore, requires some adjustment in the tax imposed in these conditions.
2. Whenever investments are held for a number of years, carrying costs of various kinds will be incurred. These are difficult to measure and take into account in determining the portion of profit to be taxed and yet some allowance must be made for them.
3. The taxation of profits on the sale of investments requires, in equity, the deduction of losses. It is



frequently very difficult to calculate such losses accurately. In practice it may be doubted if for most taxpayers the investment losses which might be allowed would not exceed profits especially if the inflation element, retained earnings, carrying charges, etc., were excluded from the taxable amounts.

4. It would also be very difficult in practice to distinguish the portions of the profits realized on the sale of investments (inflation profits, retained earnings, etc.) from other kinds of profits.

The most compelling argument against a tax on investment profits is based not on equitable grounds nor on practical considerations but on economic necessity. In a developing country such as Canada there is an overwhelming need for capital investment of all kinds and it is clearly essential for us to maintain a tax structure which will positively encourage such investment. It is the prospect of fortuitous increments in value due to the discovery of natural resources or of new products and processes which makes investors overlook the risks involved in "growth situations". It is, therefore, essential for the economic growth of the country that every incentive be given to those prepared to invest in developing enterprises. The need for such incentives is especially important in a country such as Canada which is very dependent on outside investment for much of its development capital, because in such cases, the return offered must be sufficiently more favourable than the investor's domestic alternatives to overcome his natural reluctance to send his capital abroad. Since it is almost impossible in an economy as open to world competition as Canada's to provide this extra incentive in the form of an increased gross return, it must be provided through the increase in net return permitted by a lower effective rate of tax. In view of the United States maximum rate of 25%, it seems unlikely that any rate sufficiently low to be attractive would be high enough to be worth collecting.

#### PROPOSALS FOR TAX REFORM - A NEW INCOME TAX ACT

29. Because the defects in the Canadian tax system are deeply rooted in the tax structure itself, any effective reforms must be basic and far-reaching in nature. No effective improvement in the present organization can be obtained by further patchwork amendments to the existing Acts and



it is, therefore, submitted that the significant revisions proposed below can only be implemented by the introduction of a completely new Income Tax Act. Such a complete revision will permit a fresh start, free of the innumerable inconsistencies and complexities with which the present Act is afflicted. It will also, if it is done carefully, prevent the administration of the new system from becoming bogged down in the mass of judicial interpretations which surround the basic concepts of the old Act.

30. In this section and in the remainder of the brief, income taxes are considered as a unit. It is recognized, of course, that both Federal and Provincial governments are, at present, active in this field and that changes in Federal taxes alone will not produce the favourable results expected unless both levels of government adopt the proposed changes simultaneously. The Association is aware of the difficulties involved in obtaining joint Federal-Provincial action in this area. It is, however, convinced that when serious problems are involved, the National interest will prevail and it is, therefore, assumed in the material which follows that the reforms proposed will so commend themselves to all levels of government that the necessary joint actions will be developed as required. As a result, no attempt has been made in the ensuing discussion to distinguish between levels of government concerned with specific proposals nor has any space been devoted to the alternative actions which will be required if provincial co-operation is not forthcoming.

31. Most of the discussion in the previous section and most of the proposals for reform set out below relate to the income tax alone. The income tax is undoubtedly the most significant part of the tax structure as far as economic development is concerned. There are, however, some other features of the tax structure which seem to require amendment and some proposals in connection with other taxes are, therefore, included.

32. The Association's basic proposals for reform of the Canadian tax structure are set out below. Comments, illustrations, and an evaluation of the probable effects are discussed in subsequent sections of the Brief.

33. The basic reforms proposed may be summarized as follows:

- (i) Greatly reduce the maximum rate of personal tax on higher incomes by ending the present progression of income tax rates at about 35%.
- (ii) Reduce the top corporation tax rate to 35% and at the same time increase the tax on the lower bracket to the same figure. When this is done, all corporate profits will be subject to tax at the same rate as the maximum personal rate.\*

\* As the lower rate of tax on the first \$35,000 of corporate income was intended to help equalize the effects of double taxation on small, closely held companies, it will no longer be required when the proposal in (iii) is adopted.



- (iii) Eliminate the double tax on corporate income and remove the present bias in favour of debt financing by permitting the deduction of dividends paid by corporations from the income subject to tax in the hands of the corporation.
- (iv) Establish a tax on dividends paid by Canadian corporations to non-taxpaying recipients, such as non-residents, non-tax-paying corporations, or to certain institutions (co-operatives, certain investment companies, etc.) which are not subject to the full rate of tax on dividends received.

The proposed changes would eliminate the present exemption of inter-company dividends and introduce special provisions into the tax laws to ensure that dividends paid to the above types of recipients bear at least as much tax as those received by resident individuals.

In the case of domestic corporations and those institutional investors which do not now pay the full rate of tax, this will involve the imposition of an equalizing income tax on the dividends received by such organizations. This would not represent any additional imposition of tax or new discrimination; it would merely reflect the substitution of a tax on the dividend recipient for that at present paid by the dividend paying corporation.

In the case of non-residents, this taxation plan would require the imposition of a tax at least equal to the maximum payable by a resident individual or corporation

- (v) To offset the rather substantial reduction in revenues which would result initially from these proposed reductions in tax, some extension of other taxes would be necessary. Not all of the reduction in tax would be a total loss to the revenue as it would be hoped that much of the corporation tax loss would be offset by increased collections of personal tax (both resident and non-resident) payable in respect of the additional dividends which might be distributed. It is even possible that the total tax imposed on shareholders might actually increase on the adoption of these proposals because of the very substantial number of ways in which high bracket taxpayers can at present avoid paying personal tax on corporate distributions.

If any deficiency in revenue does result, it should be made up by increasing the sales or use taxes now imposed on goods and services. These taxes would not all represent an increase in the tax burden to the consumer since they would, in many cases, merely replace that portion of the corporation tax which is at present shifted. In the event



that revenue needs required the imposition of a retail sales tax at an unacceptable rate, consideration might be given to the adoption of a multi-stage value added tax. As long as this is equitably imposed, it will spread collection back through the productive process without pyramiding tax on tax.

- (vi) As a further measure of encouragement to investment in Canadian institutions, it is suggested that trusts, insurance companies and other major investors - and/or perhaps even all investors - should be penalized slightly for investing in foreign securities. This could be done by imposing a small surtax on foreign investment income or by reducing the credit allowed against foreign taxes. If it were not considered desirable to discourage investment in foreign subsidiaries, it would be easy to provide special exemptions for the dividends received by the owners of substantial or controlling interests.
- (vii) Even with the great simplification of the tax structure which the above proposals would permit, there would still be marginal or doubtful transactions. It would therefore be desirable for the authorities to institute a system whereby taxpayers could obtain firm rulings on the tax status of proposed transactions in advance of the actual transaction. Such a system would make rational choices between alternative courses of action much easier and would eliminate a good deal of the time and effort that must now be devoted to consideration of the probable tax effect of proposed ventures.
- (viii) Clarify the present confused condition of the law regarding "capital gains" to distinguish clearly between ordinary income and profits realized on the sale of investments. It is strongly recommended that all profits realized on the sale of investment securities, in the broad sense, should continue to be exempt from tax partly in order to avoid inequities that would otherwise result but chiefly in order to provide the strongest possible incentive for both residents and non-residents to invest in the economic development of Canada. The Association believes that all such profits by investors, including short-term profits, must be exempt from tax in order to develop the broad, deep, active and effective investment markets essential to the expansion of the economy of Canada. Any tax on profits realized on the sale of investment securities, short-term and long term, would drastically reduce already



thin markets and seriously deter investment in Canada. Any such tax would have a seriously injurious effect on new issue markets and new issue financing. The Association has given careful consideration to as many factors involved in the capital gains question as is possible. In its opinion, there is very little practical benefit to any capital gains tax and there could be extremely serious disadvantages. As a result, the Association strongly recommends against the adoption of any form of capital gains tax but does suggest considerable clarification of the present ambiguous state of the law and jurisprudence relating to this matter.

- (ix) In order to give full effect to the foregoing recommendations, it would be desirable to introduce a provision which would permit any non-taxed profits realized by corporations on the sale of investments to be distributed to the shareholders free of tax. This would require a procedure for the identification of such elements in the retained earnings of corporations and for the special exclusion from shareholders' income of any distributions made out of these non-taxed elements.

#### COMMENTS AND ILLUSTRATIONS

34. The foregoing proposals would eliminate many of the objections to the present tax structure:

- (i) The reduction of tax rates to a minimum of 35% on both corporate and personal income will eliminate a large part of the disincentive effects of the present high rates and will also reduce many of the other undesirable side effects of excessively high rates - the incentive to waste money on activities of doubtful value, the temptation to remunerate employees in services instead of in cash, and the diversion of effort from productive activity to tax avoidance. A reduction of tax rates to a maximum of 35% may be considered so great as to be unrealistic. This rate has been chosen deliberately, however, on the grounds that any smaller reduction would not achieve the desired results. There can be no question that the adverse effects of high rates become very noticeable whenever the effective rate exceeds 50% and the taxpayer feels that the government is getting more than half of his marginal income. Even a 60/40 split would not eliminate the "almost half" attitude. It is felt, however, that a rate of approximately one-third would seem less unreasonable and would, therefore, be less likely



to discourage effort or to encourage avoidance.

- (ii) The elimination of the present two-stage graduation in the corporation tax rate will increase equity between shareholders in large and small corporations, increase tax collections and remove the need for the definition of associated companies which is one of the most difficult sections of the present law.
  - (iii) The elimination from the personal tax structure of all progression above a level of approximately \$10,000 of taxable income will greatly reduce the present corporate reluctance to distribute dividends. Because the rate of tax will no longer increase substantially when large lump sum distributions are made, the present penalty on subsequent distribution of earnings retained temporarily in a business will also be greatly reduced. The elimination of the double tax on corporate income will have a similar effect as there will no longer be any tax benefit to be gained by postponing distribution. It will, therefore, be possible for companies to choose between retention or distribution of earnings on economic and business grounds rather than in the light of tax considerations. The pressure towards re-investment of corporate earnings under almost any conditions and thus the pressure towards unrealistic and uneconomic expansion or diversification will be greatly ameliorated.
  - (iv) The allowance of dividends as a deduction from corporate taxable income will remove the present bias in favour of debt financing. As a result, equity financing will become more attractive. The tax structure proposed will, therefore, permit and encourage the offering of higher yield to investors in equities since it will be possible to offer such yields at a lower net cost to the corporation. These savings in financing costs should result ultimately in a reduction in the selling price of companies' products - first in highly competitive industries, but ultimately throughout the economy. The distortions resulting from the present unequal shifting of the corporate tax should thus, in time, be largely eliminated and a part of the suggested increase in sales or use taxes would be absorbed by this "reshifting" of the corporation tax.
- The substitution of an equitable tax on production or consumption in place of the present erratic one would be advantageous to the economy as a whole and, if the normal practice of exempting export sales from the sales tax is



followed, this change would make it possible to reduce the tax burden on exported goods without granting similar benefits to domestic goods or departing from existing international agreements regarding trade and tariffs.

It should be noted that even in those cases where because of strong demands for industries' products or because of a semi-monopolistic situation, all the tax saving is passed on to shareholders - if in other words the tax is not "re-shifted" - the resulting increase in return to shareholders should provide the encouragement needed to draw new participants into the industry. A similar result will occur in those industries which are now unprofitable because the price structure is such that the present tax cannot be shifted. Such industries, now unattractive to capital, should, under the new conditions, improve in their competitive position and thus become able to engage in innovation and expansion.

- (v) In addition, the elimination of the real or apparent duplication of tax on corporate earnings will equalize the position of large and small corporations and eliminate the inequities between small corporations and unincorporated businesses. This will permit the choice of legal structure and the size of the operating unit to be determined by economic and business reasons rather than by tax considerations. The elimination of double tax on corporate earnings will also permit a drastic simplification in the tax structure by rendering largely irrelevant all of the provisions regarding inter-company dividends and designated surplus as well as the special taxes on undistributed income and the complex provisions relating to the payment of dividends out of tax paid undistributed income.
- (vi) The deduction of dividends from income subject to corporation tax and the elimination of the present dividend credit will eliminate the peculiar effect of the credit in its present form. Provided that some machinery can be found for imposing an equivalent tax on non-residents and presently non-taxable entities, the resulting elimination of double tax should be more effective and more equitable. It will remove the present bias in favour of high income portfolio investors and shareholder-managers of small companies as compared with lower income portfolio investors and the owners of unincorporated businesses.

As long as the dividends paid in any year do not exceed earnings for that year, the basic application of the proposal



presents no problem. The dividends paid in a year can be treated as a deduction from the corporation income, subject to tax and all dividends can be subject to personal tax. The possible alternative method of avoiding double tax which has been traditionally used in the United Kingdom - the imposition of the basic or normal rate of tax on all corporate income and the distribution of dividends on a "tax paid" basis is believed to be unsatisfactory. It presents problems to the shareholders in determining the amount to be included in income and imposes tax on low income shareholders at a higher rate than required by the graduated tax. This latter defect can be corrected by making provision for refunds but a substantial amount of administrative difficulty is involved in doing so. There is also some doubt as to whether this indirect method of taxing dividend recipients by treating the corporation tax as a form of withholding tax actually achieves the effect intended. There is considerable evidence that investors in Great Britain look at the after tax dividend when computing yields and that tendencies to shifting therefore arise even when there is theoretically no tax actually imposed on the corporation. It is, therefore, recommended that the dividends be paid gross to shareholders and that the corporation be required to pay tax only on that portion of its income which is not distributed.

The problem which will arise when dividends paid in any year exceed earnings for the year could be resolved by the introduction of a provision to the effect that any such excess would be applied to reduce the income and taxes of previous years and thus to justify a refund to the corporation. The corporation would thus, in effect, also be able to pay out the earnings of earlier years "before tax" on the same basis as current income.

- (vii) The combination of a dividend deduction granted to corporations with the elimination of the steep progression in personal tax rates will greatly reduce the possibility of converting income into non-taxable form by holding stocks until retained earnings have been reflected in increased values. This will occur because with the elimination of double taxation, there will be no tax barrier to distribution and shares will tend to sell at their "after tax" value. This will eliminate the present anomalous situation in which accumulated earnings of corporations tend to sell for more than their actual after tax value to high income



shareholders because of the expectation that the shares will at some time be saleable to a taxpayer who, for one reason or another, will be able to make use of the accumulated earnings in the company or to withdraw them at a substantially reduced rate of tax.

- (viii) The proposed changes in the Canadian income tax structure should make Canadian equity securities more attractive to non-resident portfolio investors. In addition to raising the yield on Canadian equities and thus making them more competitive with equities issued in other countries, the conversion of the present corporation tax to the taxation plan previously outlined will benefit foreign shareholders.

Whatever procedure is followed, it is essential that no tax should be imposed on corporations in respect of earnings distributed to residents and that the non-resident shareholders bear at least as high a tax as resident shareholders.

The desirability of imposing a tax on non-residents at a higher or lower rate than that imposed on residents is, of course, subject to debate. On the surface such a discrimination against non-residents would appear to discourage foreign investment. It should not be forgotten, however, that changes in the Canadian tax on dividends paid to non-residents do not normally benefit such shareholders but merely transfer tax revenue between the Canadian government and the foreign government.

- (ix) The proposed penalty tax on foreign investment by Canadians (reference page H - 19. (vi)) may create international friction similar to that discussed in relation to the proposed changes in Canadian non-resident taxes. The introduction of such a tax could also introduce undesirable complexity into a simplified act. It might still be desirable and necessary to impose such a tax, however, if the increase in relative Canadian tax yields which should result from the elimination of double taxation and the reduction in the corporate tax rate does not make Canadian equities sufficiently attractive to compete with foreign investments on an equal footing.

#### TRANSITIONAL PROBLEMS AND SPECIAL CASES

34. It is obvious that the changes proposed cannot all be instituted at once. The distortions produced in the short run would be too serious, especially in the case of preferred and common stocks. The reduction in



corporation tax, for example, will in the short run all be passed on to shareholders and the shifted portion will probably only gradually be reflected in lower prices to consumers and lower before-tax returns on equity investments. Similarly the reduction in the top rates of tax and the elimination of the dividend credit all at once would produce serious dislocations in the securities markets and inequities to present shareholders.

35. It is, therefore, suggested that the proposed changes should be introduced gradually in accordance with some time schedule similar to that set out below:

- (i) The reduction of the corporation tax from its present levels to the suggested level of 35% should be spread over a period of about five years, producing a reduction of about 3% each year. At the same time the rate of tax at present imposed on the first \$35,000 of corporate income should be increased from its present level to 35% over the same period.
- (ii) The exemption of dividends from corporate income subject to tax will have even more significant results. The proposed exemption of dividends from corporate tax is, of course, closely related to the elimination of the present dividend credit and a formula will have to be devised which will reduce the credit at the same time that the burden of corporation tax on the dividends is reduced. Because the dividend credit in its present form affects shareholders in different tax brackets differently, the effect of these two changes in structure will be different for different classes of shareholders. There is, however, no way in which this apparent discrimination can be avoided without retaining the present inequities. At the conclusion of the five-year period all shareholders will be in the same position, paying the rate of tax appropriate to their total income level on dividends as well as on other income. Since no portion of the corporation tax will be passed on to shareholders, all shareholders will be equal in this respect.

It would appear, therefore, that the dividend deduction could be introduced over a period of about five years by permitting an increasing portion of dividends paid to be deducted each year from the income subject to corporation tax. At the same time the dividend credit would be reduced. If this were done over five years, 20% of the dividends paid by a corporation would be deductible in the first year, 40% of the dividends would be deductible in the second year and so on until 100% would be deductible in the fifth and subsequent years. The dividend credit would be reduced over



the same period at the rate of 4% per annum, to 16% in the first year, 12% in the second year, 8% in the third year and so on until it disappeared in the fifth year.

- (iii) The position of preferred shares with a fixed dividend rate will present special problems. The elimination of the present dividend tax credit will increase the personal tax on preferred shares without permitting any offset in the form of increased dividends. It would appear necessary, therefore, in the case of such shares to retain some form of dividend credit in order to avoid affecting the present holders of such shares adversely. This could be done by exempting about 50% of the dividend from tax. This special privilege would, obviously, only apply to shares outstanding at the time that the dividend credit was abandoned, since it can be assumed that preferred shares issued after the change in tax structure becomes effective, will be priced to yield appropriate returns on the assumption of full taxability of the dividends.

#### CONCLUSIONS AND ANSWERS TO SPECIFIC QUESTIONS

##### (a) SPECIFIC CONCLUSIONS

36. The above proposals should eliminate most of the major objections to the present tax structure which have been discussed above. Specifically they will:

- (i) Eliminate double tax on corporate income.
- (ii) Reduce progression in the personal tax and thus reduce the pressure to defer income in the hands of corporations. This encouragement of distribution should increase the funds available for investment, counter the present tendencies towards concentration of industry and, by improving the capital market, encourage new investment.
- (iii) They will also, by reducing the present high rates of tax to a more reasonable level, reduce some of the disincentive effects of the present tax structure, reduce the pressure to indulge in tax avoidance activities and release funds for additional investment.
- (iv) The proposals will also remove the bias in favour of debt financing. This will permit the rationalization of corporate capital structures and should ultimately be reflected in a more effective capital market. This in turn will encourage investment in economic development in Canada.



- (v) The proposals, by eliminating many of the discrepancies in the tax burden payable on similar transactions carried out through different procedures, should reduce the incentive and opportunity for tax avoidance. This will not only increase equity but it will remove the excuse for much of the effort which is now devoted to the unproductive manipulation of corporate entities. It will also, by eliminating some of the more glaring inequities in the present system, help to increase respect for the tax laws and the level of voluntary compliance .
- (vi) The greatly simplified tax structure proposed above will permit the elimination of many of the most complex and difficult provisions in the present tax laws such as those relating to the equalization of the tax burden on lump sum earnings, the dividend credit provisions, the provisions relating to the exemption of inter-company dividends, designated surplus, investment companies, non-resident owned investment corporations, personal corporations and a substantial part of the provisions relating to deemed dividends and the special taxes payable on winding-up or dissolution of corporations.
- (vii) By placing the effective rates of direct tax substantially below those in effect in the United States, they will help to reduce the outflow of trained persons to that country and encourage an inflow of educated and experienced people to Canada. As a country which is in need of population as well as of development capital, the provision of a tax climate more favourable in every respect than that of other countries is a vital necessity for national development.
- (viii) The removal of estate taxes and succession duties will eliminate one of the powerful pressures towards concentration and eliminate one of the major barriers to the development of active and prosperous small businesses.
- (ix) A slight penalty surtax imposed on income from non-Canadian investment would help to foster investment in Canada by Canadians. The level of tax needed to achieve this result would depend on the extent to which the other reforms have succeeded in improving the profitability of Canadian enterprise.
- (x) The substitution of commodity taxes for part of the present excessive income taxes will benefit economic development by removing the present disincentives to productive effort and encouraging exports by relieving them of part of the present tax burden.



(b) GENERAL CONCLUSIONS

37. Difficulties have been experienced in the past on many occasions as a result of the introduction of new tax provisions which turned out to be unworkable. Taxes are such a large part of the current economic climate that confusion and uncertainty as to the tax law can have extremely serious consequences. It is, therefore, recommended that the traditional method of introducing tax changes - complete secrecy until the full effect is announced in the budget - be eliminated and that new tax proposals be made public before they are implemented so that interested taxpayers can have an opportunity to study the proposals and to assess their implications for their own business. This preliminary publication should then be followed by formal hearings before a Committee of the House at which objections could be stated, explanations given, and possible alternatives evaluated.

38. The Association submits that at present levels of taxation, and with the present complexities of the tax structure, it is impractical as well as inequitable to make major changes in the tax burden without giving taxpayers an opportunity to make considered representations concerning the results.

39. No decision regarding tax changes of any significance can be made without some consideration of the effects of the changes on the total government revenues. The Association has therefore, attempted to evaluate the effect of the very significant recommendations made in the foregoing presentations in order to determine the cost of its proposals.

40. This has proven difficult to do since sufficiently detailed figures to permit careful calculation of the probable effects of each change are not available to the general public. Some estimates have been made, however, and these are set out below. They are submitted very hesitantly as the Association is well aware of the serious errors which the lack of adequate statistical data may inadvertently have introduced into the analysis and is conscious of the Commission's ability to produce more accurate figures if it considers them to be necessary.

41. The results of our calculations, based on Taxation Statistics for the 1960 year, suggest that the net cost of the proposed changes in income tax will be in the neighbourhood of \$500 million less any increased yield which may result from the improved economic conditions anticipated. This figure, which includes Federal and provincial taxes, has been arrived at as follows:

Reduction in personal taxes due to the elimination of all graduation above 35%		\$70 million
Reduction in corporation tax due to the reduction of the top rate to 35%	\$390 million	
Less increased tax on first \$25,000 of income	<u>60 million</u>	<u>330 million</u>
Forward		<u>\$400 million</u>



Forward		\$400 million
Reduction in corporation tax due to the allowance of a deduction for dividends paid to resident individuals	\$150 million	
Less extra tax payable due to elimination of the dividend credit	<u>50 million</u>	<u>100 million</u>
Total reduction in revenue		<u><u>\$500 million</u></u>

42. This represents slightly less than 15% of the total income tax revenue (Federal and provincial) for the 1960 tax year.

43. It should be noted, however, that this reduction in revenue would be offset to the extent of taxation revenue from presently non-tax paying entities such as co-operatives and credit unions.

(c) ANSWERS TO SPECIFIC QUESTIONS ASKED BY THE COMMISSION'S RESEARCH DIRECTOR

1. The implications of a capital gains tax.

It has been pointed out in the body of the Brief that the present position of the income tax laws with respect to so-called "capital gains" is extremely complex and includes many anomalies. An improvement in the situation can best be effected by a clarification of the distinction between ordinary income and profits realized on the sale of investments. The continued exemption of all profits realized on the sale of investments, in the broad sense, is necessary to avoid inequities which would otherwise occur and to ensure the maintenance of the broad, deep and effective investment markets essential for the optimum economic development of Canada.

2. Factors Affecting the Investment by Canadians in Equities.

It has been pointed out that the Canadian market in equities is unsatisfactory because of the scarcity of offerings and the resulting imbalance between supply and demand. It has been suggested that the thinness of the Canadian securities market is due to a large extent to the tendency to corporate re-investment which reduces the need of established companies for equity funds and the bias of the present tax structure in favour of debt financing which also reduces the offering of equities. Further factors distorting the Canadian market in equity securities are; the pressures of non-taxable institutions which being, in effect, exempt from tax on dividend income are able to bid prices of dividend producing securities up beyond the reach of the ordinary taxable shareholder; the erratic operation of the dividend credit; and the tax advantage which is, in effect, possessed by those non-residents and active businesses which are



able to use the accumulated earnings of existing companies without having to face the payment of tax on the distribution of such earnings. This latter factor is particularly important as it makes it possible for some purchasers of shares in closely held companies with large accumulations of earnings to pay prices which are substantially above the after-tax liquidation value of such shares to the individual shareholders.

It is submitted that the proposals set out in this Brief will greatly improve the Canadian securities markets. By removing the present pressures toward retention of corporate earnings (high graduated rates and the double tax on distributions) they should discourage the internal re-investment of corporate funds and provide more funds for investment in new development. By making costs of equity financing more equitable compared with the costs of debt financing, they will encourage the issue of equity securities while at the same time they will permit increases in yields to be offered at no increase in the net cost to the issuing company. The proposals will also reduce the pressures on the market which tend to drive equity yields down below reasonable levels by neutralizing the special advantages at present obtained by certain income taxpayers and institutions. The proposals will thus increase the supply and attractiveness of equity securities while at the same time increasing the supply of funds available for investment. The net effect should be a decided increase in the effectiveness of the Canadian securities market and in the availability of equity financing to new and developmental enterprises.

The suggested elimination of estate taxes and succession duties will also remove a significant barrier to private investment in smaller business enterprises. By eliminating the forced sale of private companies on the death of principal shareholders or in contemplation of such deaths, this change would encourage the continued growth of such enterprises to the point where they would be sufficiently developed to have access to regular capital markets.

3. Factors Affecting the Composition of Foreign Investment in Canada. This question has been dealt with in Part B of this Brief and it has not therefore been dealt with in this part at any length. It should be pointed out, however, that the proposals set out above will tend to eliminate some of the disadvantages at present suffered by foreign portfolio investors in contrast with foreign holders of significant or controlling interests in Canadian companies. Although the final effect will depend on the action of the foreign government, it would seem that



these proposals would place the foreign portfolio investor in a tax position more nearly equivalent to that of the holder of a controlling interest by granting him full credit for all the taxes, corporate and individual, paid on his share of the corporate income.

4. Possible Ways of Encouraging Equity Investment by Canadians Without Discouraging Foreign Investment.

For the reasons set out above, it is submitted that the proposals made in this Brief will tend to encourage equity investment by Canadians without discouraging foreign portfolio investment. None of the proposed changes in tax structure will adversely affect investment by non-residents in Canadian equities and those factors which increase yields and increase the breadth of the Canadian securities market will tend to make that market more attractive to non-residents as well as residents.

In the absence of the special tax provisions which at the present time distort the normal relationships between equity yields and debt security yields one would expect Canadian stock yields to exceed those in the United States by a small margin. The elimination of these distorting influences and the restoration of the normal relationship between stock yields and bond yields should therefore result in the establishment of Canadian stock yields at a level slightly in excess of those in the United States. This will not only make Canadian securities more attractive to American and other non-resident investors but it will also make Canadian securities more attractive to Canadians than American securities of equal stability. This should assist in the recall to Canada of the very substantial sums of Canadian savings which are at present invested in foreign securities. The suggested imposition, if necessary, of a sur-tax on foreign investment income will accentuate this tendency and provide a further incentive for Canadians to invest at home.

5. The Effect of Government Taxation and Budgetary Policy on Foreign and Domestic Investment Through its Impact on Investor Confidence.

Government policy in the taxation and budgetary fields has a very profound effect on foreign and domestic investment through its impact on investor confidence. An atmosphere of confusion and lack of long-term planning and direction will discourage both domestic and foreign investment as will a Government policy which seems to be aimed at discouraging foreign investment. If it becomes apparent that a government is not prepared to maintain economic stability or if it indicates by its policies that it is indifferent to the fate of investors or actively



opposed to their well being, the effect on investor confidence will be profound. Canada has in the past been regarded as an eminently suitable site for the investment of international capital because of its stable Government, its generally non-discriminatory tax laws, and its recognition of the rights of foreign investors to a reasonable return on their investment and to security of capital.





